United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

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76-7259

To be argued by
REGINALD LEO DUFF

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P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

THOMAS J. BYRNES and FRANCIS R. SANTANGELO,
Plaintiffs-Appellants,

—against—

FAULKNER, DAWKINS & SULLIVAN and SINGER & MACKIE, INC.,
Defendants-Appellees.

FAULKNER, DAWKINS & SULLIVAN,
Counterclaim-Plaintiff, Appellee, Appellant,

—against—

THOMAS J. BYRNES and FRANCIS R. SANTANGELO,
Counterclaim-Defendants, Appellants, Appellees,

and

TOBEY & KIRK,
Counterclaim-Defendant-Appellee.

ANSWERING BRIEF OF COUNTERCLAIM-DEFENDANTS-APPELLEES AND REPLY BRIEF OF PLAINTIFFS-COUNTERCLAIM-DEFENDANTS-APPELLANTS

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ANSWERING BRIEF OF COUNTERCLAIM-
DEFENDANTS-APPELLEES, AND REPLY
BRIEF OF PLAINTIFFS-COUNTERCLAIM-
DEFENDANTS-APPELLANTS

This Brief is submitted by plaintiffs and counterclaim-defendants, appellants, appellees Thomas J. Byrnes and Francis R. Santangelo ("plaintiffs"). Points I through IV of this Brief are submitted in opposition to the cross-appeal of defendant and

counterclaim-plaintiff-appellee-appellant, Faulkner, Dawkins & Sullivan ("Faulkner"). Points V and VI are submitted in reply, in support of plaintiffs' own appeal on the First and Second Defenses, respectively. Points VII and VIII contain both answering and reply matters since both parties appeal from the dispositions of the Third and Seventh Defenses by the Court below.

COUNTERSTATEMENT OF THE QUESTIONS
PRESENTED BY FAULKNER'S CROSS-APPEAL

1. Did plaintiffs' mere sale of registered stock to Faulkner, a market-maker, *ipso facto* make Faulkner a "participant" in the "distribution" so that its subsequent open-market purchases would constitute a violation of Rule 10b-6? If so, could Faulkner have consummated the transaction by withdrawing from its market-making activities until it had resold the balance of the shares purchased from plaintiffs?

The Court below answered the first part of the Question in the negative, and did not consider the second part. The question is considered in subpoints (a) through (d) of Point I hereof.

2. Where a party to a contract for the sale of securities purports to cancel it on authority of the SEC's interpretation of a prohibitory Rule and the interpretation is thereafter overruled by the Commission and by the District Court, is the party cancelling the contract entitled to be immunized from liability for its breach of contract either by virtue of section 23(a) of the Exchange Act or on principles of fairness and equity?

The Court below held that section 23(a) would not immunize the cancelling party from liability for breach of con-

tract, and did not consider the second part of the question because it was not raised below. We consider these questions in subpoint (e) of Point I hereof.

3. Has any court the power to create an implied right (as distinguished from a remedy) to augment two express congressionally-created rights, when the implied right is inherently inconsistent with the rights expressly conferred by the Congress, and the defenses appurtinent to them?

The Court below held that it could not recognize the existence of such a right. We consider the question in Point II.

4. Do the NASD Rules governing the obligations of notification and resale with respect to rejected securities, by their terms applicable to disputes between NASD broker-dealers, apply to resales by a customer who is not a member of the NASD?

The Court below held that they do not. The question is considered in Point III of this Brief.

5. By virtue of the limitations of sections 27 and 28(a) of the Exchange Act, does a pleading charging a violation of that Act state a claim for relief thereunder if recovery is sought only of the loss of anticipated profits on a portion of the transaction? If not, can the complaining party seek greater compensatory or punitive damages under state law on account of "the acts complained of," which allegedly violate the Exchange Act?

The Court below implicitly answered both questions in the negative. We consider these questions in Point IV hereof.

POINT I
(Answer to Faulkner's Point IV)

THE TRANSACTION IN SUIT DID NOT VIOLATE RULE 10b-6, AND FAULKNER WAS NOT PRECLUDED FROM ACCEPTING DELIVERY OF PLAINTIFFS' STOCK

Faulkner rejected the transaction in suit because its mere purchase of registered stock from plaintiffs allegedly would have violated Rule 10b-6. In its Fourth Affirmative Defense and Second Counterclaim Faulkner argues that there was an unlawful manipulation of the price of White Shield stock, that the market price was artificial, so that Faulkner could not cover the purchase from plaintiffs by open-market purchases, and either had to cancel the purchase or violate the law. Faulkner's arguments are tendentious, its reliance on Matter of Jaffee & Co., CCH Sec.L.Rep. ¶ 77,805 (1970), misplaced, and its conclusions self-serving: Rule 10b-6 was not violated.

(a) The Transaction in Suit did not violate Rule 10b-6

Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), provides in pertinent part that

> "It shall be unlawful . . . To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." (Emphasis added).

Pursuant to this grant of authority, the Commission adopted Rule 10b-6 which, subject to certain provisos, forbids three categories of person who are participating or have agreed to participate in a "distribution" of securities

> "to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, . . . or to attempt to induce any person to purchase any such security or right until after he has completed his participation in such distribution."

The three categories of person whose purchases are interdicted are "an underwriter or prospective underwriter in a particular distribution" (Rule 10b-6(a)(1)), "the issuer or other person on whose behalf such a distribution is being made" (Rule 10b-6(a)(2)), and "a broker, dealer or other person who has agreed to participate or is participating in such a distribution" (Rule 10b-6(a)(3)). While turning upon one's "participation" in a "distribution," Rule 10b-6 defines neither term.

A violation of Rule 10b-6 creates "a presumption that illegal purchases will substantially inflate the price of the security," Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 378 nt. 33 (2d Cir. 1973). However, as this Court said, "Either the purchases were prohibited by the Rule or they were not." Id., at 378. The evidence is unequivocal that the transaction in suit did not violate Rule 10b-6, as drafted, or the policies reasonably to be extrapolated from the text of the Rule: Plaintiffs themselves neither purchased nor induced anyone else to purchase stock of White Shield before they had completed their "participation" (however defined) in the "distribution" or even thereafter. Tobey & Kirk purchased no White Shield stock "for any account in which [it] ha[d] a beneficial interest."*

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*Its purchases of 1,000 shares from plaintiffs as broker for its customers were not forbidden by the Rule.

There is thus no evidence to support Faulkner's underlying assumption that the price of White Shield stock was being manipulated in violation of Rule 10b-6, and the drop in the price of the stock immediately following the declaration of effectiveness of the registration statement in suit negates the sort of manipulation to which Rule 10b-6 is addressed, because a substantial increase in the supply of a security tends to depress its price. Goldstein v. Regal Crest, Inc., 42 FRD 571, 574 (E.D.Pa. 1974); Faulkner's Brief, p. 64.

However, the Fourth Affirmative Defense does not invoke Rule 10b-6 as written. It rests upon the unprecedented reading of Rule 10b-6 by a transitory majority of the Commission in Matter of Jaffee & Co., CCH Sec.L. Rep. ¶ 77,805 (1970), one that depends upon a misquotation of Rule 10b-6 and has since been repudiated by the Commission in Matter of Collins Securities Corp., CCH Sec.L.Rep. ¶ 80,327 (1975).

(b) The Jaffee per se Rules have no warrant in Rule 10b-6 and forbid conduct which is not "manipulative or deceptive"

The two principal holdings of Jaffee were to equate every offering of stock registered under the Securities Act of 1933 with a "distribution" under Rule 10b-6, and to equate every purchase of registered stock with a "participation" in the "distribution." Under Jaffee a market-maker's open market purchases would violate Rule 10b-6 if they follow the purchase of registered stock which makes him a "participant" in the distribution.

Jaffee arose out of a registered distribution of the stock of Solitron Devices, Inc., comprising some 28% of the outstanding stock. All such shares were being offered through Lee & Co. as "exclusive agent" for all the selling shareholders. Jaffee's own testimony established, CCH Sec.L.Rep. ¶ 77,805, at p. 83,858 (Plfs. Addendum, p. 120), that he had violated Rule 10b-6:

> "Jaffee, although he was one of the selling stockholders under the registration statement, made purchases of Solitron stock for his own account during the relevant period, and admitted that prior to that period but during the course of the Solitron offering he had asked Horn to 'go into' the sheets. Thereafter, Horn . . . entered bids for the stock."

Horn was the "trader" for Greene & Co., which thus became a market-maker in the stock of Solitron at the request of Jaffee, one of the stockholders "on whose behalf such a distribution [was] being made" (Rule 10b-6(a)(2)), in violation of one of the express prohibitions of Rule 10b-6(a).

The Commission unanimously found that Jaffee and Jaffee & Co. had violated Rule 10b-6, a finding which this Court affirmed as to Jaffee and reversed as to Jaffee & Co., Jaffee & Co. v. SEC, 446 F.2d 387 (2d Cir. 1971), but the facts relating to those two respondents have no application to any party in this action. What is relevant in Jaffee is that by a two-to-one majority, the Commission also found violations by Lee & Co. (the analogue to Tobey & Kirk herein), Horn (the analogue to MacMillen or Lattuga) and Greene & Co. (the analogue to Faulkner and Singer & Mackie). These respondents did not appeal their relatively light sanctions,

and the rationale on which they were sanctioned was not considered by this Court. Accord, Matter of Collins Securities Corp., CCH Sec.L. Rep. ¶ 80,327, at p. 85,000 nt. 14 (1975)(Plfs. Addendum, p. 140). But it is the Commission's unreviewed two-to-one condemnation of Greene & Co., Horn and Lee & Co., on which the Fourth Affirmative Defense and Second Counterclaim are based.

The rationale of Jaffee's condemnation of Lee & Co., Greene & Co. and Horn is found in two footnotes contained at p. 83,858 (Plfs. Addendum, p. 120), which demonstrate that pique and misquotation, rather than the "considerable expertise" of the two Commissioners who formed the transitory majority in Jaffee, led to the unprecedented and now repudiated gloss on Rule 10b-6 which that decision represents. Footnote 6 concedes:

> "The only evidence of Jaffee's arrangement with Horn is contained in a transcript of Jaffee's prior investigative testimony portions of which were received in evidence only against Jaffee and therefore cannot be used against Horn [or Greene & Co.]".

Faced with the possibility that its sanction of Greene & Co. and Horn might be restricted to their violations of other provisions of the two Acts, and that there might be no basis whatever for sanctioning Lee & Co., the Jaffee majority in effect rewrote Rule 10b-6 to create a per se violation out of acts which are neither "manipulative [n]or deceptive," nor condemned by the text of Rule 10b-6, the redefinition itself misquoting Rule 10b-6(a), id., nt. 5 (Plfs. Addendum, p. 120):

> "Although G[reene &] Co. does not meet the definition of 'underwriter' in Rule 10b-6(c)(1)---which is narrower than that in Section 2(11) of the Securities Act, the prohibitions of the Rule are applicable to 'any person who * * * is participating' in a particular distribution 'directly or indirectly' (10b-6(a)(3))."

By reading "directly or indirectly" to modify "is participating" in the introductory subdivision (3) of Rule 10b-6(a), rather than as modifying the "to bid for or purchase" in the body of the Rule, the Jaffee majority held that Horn and Greene & Co. violated Rule 10b-6, without reference to Jaffee's inadmissible testimony, solely by virtue of their undisputed purchases of distribution stock; and it could condemn Lee & Co. as their aider and abettor because Lee & Co. admittedly knew that Greene & Co. was in the Pink Sheets.

However, as Judge Werker recognized below, CCH Sec.L. Rep. ¶ 95,463, at p. 99,353 (A-19),

> "the SEC has at least misquoted, if not misread Rule 10b-6 in reaching its decision in the Jaffee case. In deciding that Greene [& Co.] was a participant in the distribution, it read Rule 10b-6 to state that its prohibitions reach anyone who is participating directly or indirectly in a particular distribution. . . . The problem is that the words 'directly or indirectly' do not modify 'is participating' as the SEC quoted it in Jaffee, supra at 83,858. Rather, 'directly or indirectly' modifies 'bid for or purchase' which is separated from the words in question by several other modifiers. . . . But the context as well as the original enactment indicate that [the Commission's] reading to be in error. This court does not accept therefore the defendant's contention that it ought to defer to the agency's interpretation since that interpretation is based at least in part on a misreading of the statute."

While Faulkner calls the Commission's misquotation of Rule 10b-6 an "immaterial question of grammar" (Brief, p. 83), the flaw in Jaffee is not immaterial,* and is not merely grammatical.

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*Construing "directly or indirectly" to modify the term "participating" in Rule 10b-6(a)(3) necessarily renders it inapplicable to subdivisions (1) and (2), and so would permit underwriters, prospective underwriters, issuers and selling shareholders covered by those subdivisions "indirectly" to bid for or purchase "such" stock while still participating in the distribution, a result wholly inconsistent with Rule 10b-6.

Indeed, apparently without even noticing the grammatical error, Commissioner Smith's dissent stressed that the decision violated the principles of Rule 10b-6 and threatened to create an unmanageable and disorderly market, by ignoring precedent, regulatory policy and market effect. Although primarily stressing the error of equating every registered offering with a "distribution" under Rule 10b-6, he also noted the anomalies created by the majority's "purchase equals participation" holding, which he considered to be merely the corollary of the "registration equals distribution" holding, CCH at pp. 83,863-64 (Plfs. Addendum, pp. 125-26).

Faulkner justifies Jaffee because a market-maker "would be creating the market price of the stock with its own purchases and quotations while at the same time selling the stock to the public" (Brief, p. 69). Yet this fear is illusory, at least when numerous market-makers are trading the security (here there were between 12 and 17 (A-108)), as Judge Friendly's dissent from denial of reargument en banc in Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1176 (2d Cir. 1970), made clear:

> "When a reputable house like Smith Barney acts as one of several market makers, as was the case here, it serves a highly desirable purpose in reducing the spreads characteristic of over-the-counter trading. It has been widely recognized that the 'best price' can be obtained by dealing directly with market makers, for one reason because a commission to an intermediary is avoided. . . . The district judge's fears concerning the ability of a market maker to set an arbitrary price are inapplicable when as here there were several market makers, as Smith Barney pointed out in its post-trial motion and the SEC now confirms in its letter to us as amicus curiae. So far as concerns the fears of ulterior motives voiced by the district judge and now by the court, the market maker, who buys as well as sells, is less likely to be interested in palming off a stock than a dealer with only a long position."

The nature of the market-maker's business makes his interests adverse to those of the person on whose behalf a distribution is being made, or of underwriters participating in such distribution. Whereas the issuer or selling shareholder seeks to obtain as high a price as possible for his stock (and the underwriter must sell out the issue), the market-maker, whose business is buying and selling, must gauge the probable effect of the distribution on the market price, and peg his bids and offers so as to assure himself a small trading profit on each transaction. His trading profits do not depend upon the level of the market price.

In *Jaffee*, the majority had cited earlier authority for the proposition that a "distribution", for Rule 10b-6 purposes, "comprises 'the entire process by which . . . a block of securities is dispersed and ultimately comes to rest in the hands of the investing public," CCH Sec.L.Rep. p. 83,858 nt. 5 (Plfs. Addendum, p. 120), concluding that the market-maker was therefore an indispensable step in the distribution process. Even were that true in *Jaffee*, it begs the question to assume that in every distribution the market-maker is but a step in the distribution.

In a very real sense the market-maker is the surrogate of the investing public, absorbing in a principled way the newly distributed stock into the previously floating stock, and making all shares fungible. In the real sense the security being distributed "comes to rest in the hands of the investing public once it has been acquired by a market-maker whose own economic interests (apart from a slight mark-up which does not depend upon the prior

character of the security) are indistinguishable from those of the investing public, but entirely adverse to those of the selling shareholders or issuer.

This appreciation will not prevent or make more difficult the enforcement of Rule 10b-6, it will facilitate it. Where a market-maker participates in the seller's efforts to get the highest price for his stock by inserting artificially high bids in the Pink Sheets, the courts and the Commission have readily been able to condemn the manipulations without resorting to the untenable _Jaffee_ _per_ _se_ holdings. _See_, _e.g._, _SEC_ v. _Resch-Cassin & Co., Inc._, 362 F.Supp. 964 (S.D.N.Y. 1973)(which does not mention _Jaffee_); _Matter of Collins_ _Securities Corp_., CCH Sec.L.Rep. ¶ 80,327 (1975). In contrast, excluding market-makers merely invites arbitrageurs into the process of absorbing the new stock, and their activities are more difficult to monitor and would encourage violations of Rule 10b-6.

In _Ernst & Ernst_ v. _Hochfelder_, ___ U.S. ___, 47 L.ed.2d 668, 679-80 (1976), the Supreme Court stressed that the term "manipulative"

> ". . . is and was a term of art when used in connection with securities markets. It connotes intentional or willful conduct _designed_ _to_ _deceive_ _or_ _defraud_ _investors_ by controlling or artificially affecting the price of securities." _Id._, at 680 (Emphasis added).

As applied to a casual purchase of registered stock, _Jaffee_ was a completely unwarranted extension of Rule 10b-6, arbitrarily condemning conduct which was neither "manipulative [n]or deceptive," and was beyond the Commission's authority.

(c) Jaffee did not preclude Faulkner's consummating the transaction in suit

Even if Jaffee were a proper reading of Rule 10b-6, it furnishes no warrant for Faulkner's assumption that the mere purchase by Faulkner of registered shares, or the mere sale to Faulkner of registered shares, violated Rule 10b-6. All that it forbade was open-market purchases by Faulkner until it had resold plaintiffs' stock.* Thus, even if Jaffee were a valid reading of Rule 10b-6(a), it would not have precluded consummation of the transaction in suit.

In the first place, two Provisos to Rule 10b-6(a) itself seem to exempt the transaction in suit from the prohibition of Rule 10b-6(a). Thus, the trade might have been held to come within Proviso (5) to Rule 10b-6(a), as a "brokerage transaction not involving solicitation of a customer's order," or within Proviso (6), as an "offer to sell or solicitation of [an] offer to buy the securities being distributed . . . as principal by the person making such offer to sell or solicitation."

Moreover, apart from the Provisos, in Jaffee itself the Commission recognized that one who inadvertently acquires regis-

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*Faulkner finds some comfort in Judge Gurfein's obiter dictum, 362 F.Supp. 864, 868 nt. 3 (S.D.N.Y. 1973)(A-29): ". . . Jaffee held that it is a violation of Rule 10b-6 under the 1934 Act for a selling broker to sell stock included in a registration statement to a market-maker, or for a market-maker to participate in the distribution, because it would be creating a market price by its own purchases and quotations." On reargument we urged Judge Gurfein to withdraw or modify the footnote because it does not accurately reflect either Rule 10b-6 or the Jaffee gloss. Since Judge Gurfein was not deciding the Fourth Defense, he denied the relief sought.

tered stock may avoid a violation of Rule 10b-6(a) by discontinuing further bids or purchases until after he has resold the registered stock. Rule 10b-6 itself merely prohibits any "participant" in a distribution subject to the Rule from making any open market purchases of the stock being distributed or similar stock, until after he has completed his "participation" in the "distribution." All that _Jaffee_ added was that the mere purchase of registered stock by a market-maker made him a "participant" in the distribution.

However, even on this reading, a single purchase of registered stock does not violate Rule 10b-6 if the purchaser makes no further purchases before selling out the registered stock. Liability in _Jaffee_ was premised---in the case of Greene & Co. (and Lee & Co.)---upon _repeated_ purchases (or sales). In the case of Greene & Co., the _Jaffee_ majority said, p. 83,858 (Plfs. Addendum, p. 120):

> "_With every such purchase of stock_ [from Lee & Co.] _and until such shares were resold_, G[reene &] Co., which received copies of the Solitron prospectus from Lee and thus was aware that a distribution of registered Solitron stock was in progress, _became a participant in the distribution and subject to the prohibitions in Rule 10b-6_. _Nevertheless, while participating in that distribution_, _G[reene &] Co., through Horn, not only continuously inserted bids in the quotation sheets_ published by the National Quotation Bureau, Inc., _but also effected purchases for its own account of Solitron stock that was not a part of the offering_. Horn had also received a copy of the Solitron prospectus from Lee. _Thereafter, before making purchases of Solitron stock from that firm, he should have inquired into the status of the offering so as to determine whether to discontinue bids for the stock and purchases of stock not a part of the offering_." (Emphasis added).

Similarly, the liability of Lee & Co. was premised not upon a casual sale to a market-maker, but upon repeated and continuous sales to a market-maker who the seller knew was continuing its market-making activities, *ibid.*:

> "*Lee's president* testified that he examined the sheets every day and *knew that* G[reene &] *Co.*, *was entering bids as well as offers for Solitron stock throughout the relevant period. Yet Lee continued to sell registered Solitron stock to* G[reene &] *Co.*, *and* therefore, contrary to the examiner's finding, *knew or should have known that* G[reene &] *Co.*, *was participating in the distribution. By such sales Lee aided and abetted* G[reene &] *Co.*'s *violation of Rule 10b-6.*" (Emphasis supplied).

In contrast to Lee & Co., plaintiffs and Tobey & Kirk had no reason to believe that Faulkner could not lawfully take the stock: It bought a relatively small block of stock from plaintiffs and could have resold it while discontinuing further open market purchases. As found below, p. 99,354 (A-20), Faulkner bought from plaintiffs only 3.5% of the stock sold pursuant under the two "integrated" registrations or only 1.4% of the total stock being distributed in all four secondaries,* and on the very day of its purchase from plaintiffs, and without any "selling effort" beyond the two telephone calls it presumably placed to its vendees, it resold 45% of the stock so purchased.

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*Faulkner suggests that the Commission's "integration" of two of the White Shield registration statements was only for 1933 Act purposes (Brief, p. 72 nt.). However, it seems appropriate to treat all four registrations as one "distribution," given the Commission's concern, *Jaffee* at p. 83,859 (Plfs. Addendum, p. 121), that if *all* selling shareholders are not considered participants in the distributions of all others for Rule 10b-6 purposes, they could severally avoid the prohibitions of the Rule by coordinating their sales of registered stock and their open-market purchases.

Moreover, although Faulkner repeatedly harps on the fact that plaintiffs sold their stock to seventeen broker-dealers of whom fourteen were market-makers, it is stipulated that 50.76% of plaintiffs' shares were sold to broker-dealers which were not market-makers (McDonald Shobar 200 shares; Leason & Co. 71,900; Tobey & Kirk 1,000; Stip. ## 5, 6, A-101-02); 30.56% were sold to Faulkner; and only 26,900 shares, or 18.68%, were sold to other market-makers,* mostly in small lots, and without any selling effort.

Since the transaction between Tobey & Kirk and Faulkner was an isolated one and Faulkner could lawfully have consummated the trade by discontinuing its open market purchases, the facts which led the Jaffee majority to hold Lee & Co. to be an aider and abettor of Greene & Co.'s putative violation simply do not apply, and there is no similar basis for ascribing to Tobey & Kirk (or to plaintiffs) knowledge of a "violation" which was not bound to occur. However, Faulkner contends that because of Proviso 11 to Rule 10b-6(a), it could not have avoided a violation of Rule 10b-6 merely by terminating its market-making activities. Proviso (11) makes the prohibitions of Rule 10b-6(a) inapplicable to:

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*The Record does not disclose how many of these market-makers, like Singer & Mackie (A-61, ¶ 72), purchased plaintiffs' stock as agents for their own customers (in which case Rule 10b-6 does not apply), or to fill a "short" position (in which case they might be deemed already to have sold the registered stock before making further purchases, so there would be no violation).

> "purchases or bids by an underwriter, prospective underwriter or dealer otherwise than on a securities exchange, 10 or more business days prior to the proposed commencement of such distribution (or 5 or more business days in the case of unsolicited purchases), if none of such purchases or bids are for the purpose of creating actual, or apparent, active trading in or raising the price of such security."

It should be self-evident that Proviso (11) provides an exemption from the prohibitions of Rule 10b-6 for those who, by reason of their agreement to participate in a distribution or because of their prior knowledge of the impending distribution, are able to terminate their open-market activities sufficiently before the distribution commences. The Proviso was not intended to operate as an additional prohibition, entrapping as inadvertent violators of the Rule those who became unwitting and unwilling "participants" through a casual purchase of registered stock. Faulkner reads the proviso to achieve this result (Brief, p. 90), concluding, *id*., p. 91, that "the only possible way for Faulkner to avoid violating Rule 10b-6 was for it to reject the stock." However, in the Court below the Commission rejected this interpretation of the Proviso (*Amicus* memorandum pp. 14-15, nt. 24):

> "24. If there is no prior agreement to participate, the prohibitions of the rule would not apply until the earlier of the time at which the dealer becomes a prospective underwriter, as defined in the rule, or actually commences his participation in the distribution."

The "prohibitions of the rule" are against purchasing stock while "participating" in the distribution. If Faulkner's "participation" commenced with its first purchase from plaintiffs it would

not violate the Rule if it made no further purchases. Thus, even assuming the correctness of Jaffee, it would have avoided a violation by immediately withdrawing from the Pink Sheets upon receiving a copy of the prospectus showing that it had purchased registered stock, and by staying out until it had resold the remaining 24,000 shares. This would not have been too great a burden since it actually withdrew from the market in White Shield stock some two weeks after the trade (A-102, # 8).*

(d) The Collins Decision Overrules Both per se Aspects of Jaffee

While the motions for summary judgment were pending below, the Commission unanimously overruled Jaffee. Matter of Collins Securities Corp., CCH Sec.L.Rep. ¶ 80,327 (1975). Faulkner contends that Collins left unaffected the Jaffee holding which equates the mere purchase of registered stock with "participation" in the distribution. Plaintiffs and the Court below read Collins as repudiating the "purchase equals participation" corollary of Jaffee as well as "registration equals 10b-6 distribution" holding, since the two are mutually interdependent.

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*To the extent that Faulkner now suggests that it might have become a "prospective underwriter" because its telephone conversations with Santangelo began on June 1, 1971, so that it could not withdraw by reason of Proviso 11 and still satisfy the Rule (Brief, p. 90), obviously this suggestion is completely inconsistent with its claim that it did not know that it had purchased registered stock until it received the stock and prospectus on June 15, 1971. Yet, any purchases which it may have made prior to the receipt of the prospectus were made at a time when it would have had no incentive to manipulate the price of White Shield stock, and the incentive and ability to manipulate is the very premise of Jaffee's application to market-makers. Cf., Collins, p. 85,800 (Plfs. Addendum, p. 140).

In Collins there was ample evidence that the respondent had made artificial bids for and purchases of the underlying security in order to raise its price so as to induce the exercise of outstanding warrants. The respondent there did not contend that it would not be a "participant" in the distribution, if it was a distribution, but argued that there was no distribution and that it was not an underwriter under Rule 10b-6(c)(p. 85,799, Plfs. Addendum, p. 139). It was in response to these contentions that the Commission explicitly overruled what Faulkner calls the "Second Holding" of Jaffee.

Repeating and adopting the very distinctions which Commissioner Smith's Jaffee dissent had unsuccessfully emphasized, between the Securities Act and Rule 10b-6, the Commission concluded in Collins, id., at p. 85,800 (Plfs. Addendum, p. 140), that:

> "If the term distribution in Rule 10b-6 were to be equated with the concept of public offering or distribution in the Securities Act, this would not only extend the restrictions of Rule 10b-6 beyond their intended purpose but could result in unnecessary disruption of the trading markets, particularly where an exchange specialist or other market maker acquires registered stock in the performance of his normal functions. It would obviously make no sense to conclude that a specialist, who happens to acquire some registered stock in the course of his normal activities, has to get out of the market until after he has disposed of that stock. No one has ever thought that such a result was required even though specialists might well purchase registered stock being sold under a so-called 'shelf registration.'
>
> "We accordingly decline to hold that any offering of securities pursuant to a registration statement automatically constitutes a distribution within the meaning of Rule 10b-6, and the Jaffee decision, insofar as it is to the contrary, is overruled." (Emphasis added).

Far from reaffirming the "purchase equals participation" holding of Jaffee, the above-quoted language itself demonstrates that the Commission recognized that the so-called "First Holding" has no validity. Speaking of exchange specialists, and equating them with over-the-counter market-makers, the Commission explicitly held that

> "No one has ever thought . . . [that a specialist or market-maker who] acquire[s] some registered stock in the course of his normal activities, has to get out of the market until after he has disposed of his stock."

This statement is a complete resilement from the "First Holding" of Jaffee (compare, CCH Sec.L.Rep. ¶ 77,805, at p. 83,860 nt. 12a, Plfs. Addendum, p. 122).

As Faulkner concedes (Brief, pp. 75-76), the clear evidence of the broker-dealer's actual "participation" in the distribution in Collins made it unnecessary for the Commission to overrule explicitly what Faulkner calls Jaffee's "First Holding." However, were the Commission merely reaffirming the "purchase equals participation" holding of Jaffee it would have had no need to examine in such detail the respondent's activities in order to prove its "participation" and its violation: The "participation" would have been proven from the respondent's admitted purchases if the "First Holding" of Jaffee were still the law. Yet the Commission's finding of respondent's "participation" in the Collins distribution was not premised upon a single purchase of registered securities, but upon the respondent's extensive actual participation in and masterminding of the manipulative scheme.

Finally, in overruling the "registration equals distribution" holding of Jaffee, the Commission was only conceding that it might have been too didactic, while warning that registration normally would involve a Rule 10b-6 distribution. No mea culpa was necessary to infer its abandonment of the "purchase equals participation" holding of Jaffee, which was simply grammatically and economically wrong. Since Jaffee's overall holding is now overruled by Collins, Judge Werker's recognition that Jaffee itself misquoted and misconstrued Rule 10b-6 does not create an unseemly war between the Commission and the courts, as Faulkner suggests (Brief, pp. 80-85).

(e) Faulkner is not relieved from its liability for breach of contract either by section 23(a) of the Exchange Act or on more general principles of fairness

Faulkner argues that because it in good faith relied upon Jaffee in cancelling the transaction in suit, no liability can be imposed on it for its breach of the contract of sale, either by virtue of section 23(a) of the Exchange Act, 15 U.S.C. § 78w(a), or on more general principles designed to encourage compliance with law or administrative regulation.

As to the first ground, the conceptual difficulty is that section 23(a) explicitly states that

> "No provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission . . . notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason." (Emphasis added).

The liability sought to be imposed by the present action manifestly is not a liability imposed by any provision of the Exchange Act. It is a claim of damages for breach of contract. Section 23(a) has never been held to apply to exculpate someone from liability for breach of contract, only to exculpate a defendant from a liability imposed by the Act.

Thus, in Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957); Van Aalten v. Hurley, 176 F.Supp. 851 (S.D.N.Y. 1959); and Perlman v. Timberlake, 172 F.Supp. 246 (S.D.N.Y. 1959), defendants had sold securities in conformity with an SEC Rule 16b-3, which exempted the sales from liability under section 16(b) of the Act, 15 U.S.C. § 78p(b). Although the exemptive rule was held invalid, section 23(a) was applied to immunize the defendants from the underlying liability imposed by section 16(b) itself, because defendants' sales had been made in conformity with the invalid SEC regulation.

Similarly, in Gerstle v. Gamble-Skogmo, Inc., supra, 478 F.2d 1281, 1284 (2d Cir. 1973), defendants, relying upon the Commission's longstanding prohibition against giving "projections" in proxy statements and prospectuses, omitted projections from their proxy statement. This Court upheld the protective principle of section 23(a) against the Commission's volte face suggesting that the omission of the "projections" violated Rule 14a-9.

Again, in SEC v. Harwyn Industries Corp., 326 F.Supp. 343 (S.D.N.Y. 1971), the defendants had "spun off" unregistered securities in conformity with an SEC release which held that a stock dividend was not a "sale" requiring registration under the

1933 Act, an interpretation which Judge Mansfield rejected in Harwyn itself. However, while holding that the defendants had violated section 5, Judge Mansfield denied an injunction, and thus refused to "impose" a "liability under the Act" for conduct conforming to an invalid rule or regulation thereunder.

The Court below rejected the "strained" section 23(a) argument, nor was it impressed by the fact that the Commission as amicus had supported the novel reading, CCH Sec.L.Rep. ¶ 95,463 at p. 99,353 nt. 26 (A-19):

> "To avoid reaching the question of the validity of Jaffee itself or its direct applicability to the case at bar, the SEC adopted a strained reading of Section 19(a) of the Securities Act and Section 23(a) of the Securities Exchange Act to make those sections cover the defendant's potential liability in a breach of contract action. . . . [although] It is inconceivable that at the time [the Commission's amicus] brief was filed the SEC sincerely believed in the validity of the Jaffee ruling. Both the theory of the brief and the timing of the Collins case support that view. This court expressly disapproves of the tactics engaged in by the SEC in this matter and feels it appropriate to so state on the record."

Beyond the language of section 23(a) which on its face excludes the applicability of the section to a contract liability, the conceptual fallacy in Faulkner's contention is that it seeks to apply the exculpatory provision to the wrong kind of Commission rule or regulation. Necessarily, SEC rules or regulations are of two types: those containing prohibitions and those containing exemptions from prohibitions or liabilities otherwise created by the Act or other regulations. Necessarily section 23(a) can apply only where a party has conformed his conduct to

an exemptive rule or regulation, which would have shielded him from other prohibitions of the Act, and the exemptive rule or regulation is overruled, thereby exposing his conduct as being violative of the underlying prohibition. Section 23(a) thus enacts a concept of fairness and equity into the Exchange Act.

In the present case Faulkner claims no "reliance" on, or conformity with, any exemptive rule or regulation: It claims to have relied on a prohibitory regulation as grounds for refusing to perform a contract. The declaration of the invalidity of the prohibitory regulation on which it purported to rely in cancelling the contract did not expose Faulkner to any underlying liability under the Act, since Faulkner does not claim that it entered into the contract in reliance upon *Jaffee*.* The overruling of *Jaffee* merely makes legally insufficient Faulkner's putative reason for cancelling the trade.

In contrast to section 23(a), which necessarily applies to exemptive rules and regulations and provides a back-up protection when reliance on an exemption proves illusory, section 29(b), 15 U.S.C. § 78cc(a), applies to prohibitory rules or regulations: If a contract is found to violate the Act or a

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*Had Faulkner consummated the trade in suit, withdrawing from open-market purchases in reliance upon the language in *Jaffee* which suggests that such discontinuance would suffice, CCH Sec.L.Rep. ¶ 77,805, at p. 83,858 (Plfs. Addendum, p. 120), and had the Commission or a court thereafter held such exculpatory language inconsistent with Proviso 11 to Rule 10b-6(a)(on Faulkner's present reading of that Proviso), then section 23(a) or principles of fairness and equity might apply to shield Faulkner from liability under the Act, because the repudiation of the *Jaffee* exculpatory language would, in that situation, unfairly expose Faulkner to liability for violation of Rule 10b-6.

prohibitory regulation thereunder, it is voidable by virtue of section 29(b). If it is not violative of the Act or a prohibitory regulation, the contract is unaffected.

Faulkner's effort to twist section 23(a) into a back-up for a failed section 29(b) argument must be rejected not merely because, as Judge Werker said, the effort involves "a strained reading" of the statute, CCH Sec.L.Rep. ¶ 95,463, at p. 99,353 nt. 26 (A-19), but more importantly, because to give it the reading urged would be contrary to the principles of the Act by expanding section 29(b) to make void not only contracts which actually violate the Act but also those which were unilaterally cancelled in the mistaken belief that they violated the Act.

Evidently recognizing that its section 23(a) argument is as unlikely to prevail here as in the Court below, Faulkner advances a new version of the argument not made below (pp. 87-88):

> "Where an administrative determination requires rather than permits, an act or omission, liability may not be imposed in a civil action for acting in compliance with the determination."

At page 90 Faulkner adds the unwarranted conclusion that "Under the law as interpreted [in Jaffee], Faulkner had no choice but to cancel those contracts," and states (id., p. 92):

> "Hence, to permit even the possibility of liability for an act mandated by an administrative interpretation of a rule such as 10b-6 would not only be grossly unjust and completely inconsistent with principles of fairness and equity, but can only serve to encourage the conduct which the regulation was designed to prevent."

There are several fairly obvious answers to this new argument. In the first place, whatever may be the propriety of such an argument under statutes or regulations which provide no exculpatory provision of their own, to recognize it here is to expand upon an express exculpatory provision contained in section 23(a) which does not support immunity on the facts. Cf., A. C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 41-43 (1943)(quoted at p. 50 of our Principal Brief).

Secondly, as we have noted, Jaffee did not "require" cancellation of the trade. Faulkner could have withdrawn from the market and complied both with Rule 10b-6 as construed in Jaffee and with its contract obligations to plaintiffs. Moreover, Jaffee seemed to impose an independent duty on Faulkner to keep itself abreast of developments in White Shield stock. Thus it cannot properly claim "good faith conformity" with Jaffee.

Far from discouraging lawlessness, Faulkner's new rule will encourage it because brokers burdened with obligations under the statute or regulations would be encouraged to make no independent investigations of the validity of purchases which they are about to make, knowing that they will have a minimum of seven days in which to determine whether "in good faith" to cancel the contract if the market goes down, on the basis of a tenuous federal violation. If the broker cancels the contract, he defends against a breach of contract action on the basis of the putative violation, and the more novel or ingenious the claimed violation, the better his chances because, on Faulkner's new contention, he

escapes liability if he can persuade a court to believe that his cancellation had a tenable basis. But precisely this sort of heads-I-win-tails-you-lose approach to the consummation of securities transactions was itself condemned by this Court as manipulative in A. T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967), with the Commission's endorsement as amicus, ibid.

Nor can Faulkner's new-found rule of non-liability be defended on "principles of fairness and equity." One who seeks equity must do equity, and Faulkner's new theory deprives plaintiffs of any equity. By hypothesis plaintiffs did not violate Rule 10b-6 by their sale. It is undisputed that for about a week after the initial rejection of their stock, Faulkner's in-house counsel, Marc R. Green, never even bothered to reread Jaffee before "finally" cancelling a trade for $616,000 on its purported authority (A-406-07, 424). Moreover, any determination as to the validity of the contract under Jaffee was not one which Faulkner had to make unaided, risking condemnation and sanctions by the Commission, as it suggests (Brief, p. 91). Rule 10b-6(f) entitled it to ask the Commission to rule on the validity of the transaction, or to exempt it. A final determination as to whether or not to honor the contract could readily have awaited a ruling by the Commission's Staff.

Finally, Faulkner's new argument will "encourage compliance with the law" only in those situations in which the transaction is still executory and the party invoking Faulkner's rule can thus force the other party to sue: Had Faulkner accepted the

stock in suit and paid for it, the exculpatory rule it now espouses would not permit it to <u>recover</u> the purchase price in the face of a holding that Rule 10b-6 had not been violated.

In short there is no factual or legal underpinning for the Fourth Defense, or, <u>a fortiori</u>, for Faulkner's Second Counterclaim. Rule 10b-6 itself was not violated by the transaction in suit. <u>Jaffee</u> did not forbid the completion of the transaction, but in any event was a misinterpretation of the Rule. Section 23(a) or other public policy considerations do not shield Faulkner from liability for its breach of contract. The Court below correctly granted summary judgment to plaintiffs dismissing the Fourth Affirmative Defense and Second Counterclaim, and its decision thereon should be affirmed.

POINT II
(Answer to Faulkner's Point V)

THE COURT BELOW PROPERLY GRANTED SUMMARY JUDGMENT TO PLAINTIFFS ON FAULKNER'S FIFTH DEFENSE BECAUSE IT PURPORTS TO INVOKE A RIGHT NOT GIVEN BY THE SECURITIES ACT

Faulkner's Fifth Affirmative Defense asserts the right of a purchaser of registered stock to cancel a purchase after a reasonable opportunity to read the prospectus, even if the prospectus fully conforms to the requirements of the Securities Act and does not misrepresent or omit to state any material fact. No statute or judicial decision is cited in support of such right. Judge Werker held, CCH Sec.L.Rep. ¶ 95,463 at p. 99,355 (A-21), that to recognize such a right would be to "judicially amend"

section 12 of the Securities Act, 15 U.S.C. § 77l, to add a third basis for rescission to the two explicitly provided by Congress. Judge Werker also recognized that the drafters of sections 5 and 12 had contemplated situations in which a purchase could be lawfully consummated without the purchaser's ever actually having read the prospectus in advance. Ibid.

Faulkner criticizes this holding on two grounds. It argues that the limitations inherent in section 12 were improperly applied because what it is seeking is the judicial recognition of a substantive right to rescind, and specifically disclaims that it is seeking the creation of an implied remedy (Brief p. 96): "Faulkner never suggested that the District Court imply a cause of action in a circumstance not provided by § 12."

With respect, the argument is specious. Courts have regularly implied remedies for statutes which create rights or prohibit conduct where violations of those statutes result in injury to members of the class for whose protection the statutes were enacted. No authority known to plaintiffs recognizes the power of any court to fashion a substantive right to augment a detailed and comprehensive statute enacted by Congress, particularly where the proposed right is inconsistent with rights granted by Congress and would result in the elimination of defenses explicitly granted by Congress.

Moreover, to create an implied "right" without simultaneously creating a remedy for infringement of that "right" ig-

nores the maxim ubi jus, ibi remedia, and is ridiculous, so that, despite its eschewal, Faulkner is pressing for the creation of a "remedy" in addition to those carefully articulated by Congress in section 12. As Faulkner's argument boils down, the remediless pseudo-right it seeks would be available to and would only benefit someone who had cancelled a transaction on unrelated grounds and seeks additional justification for the cancellation. That is not a "right". It is a litigation ploy.

Faulkner's second ground for attacking Judge Werker's conclusion purports to be founded upon a throw-away line in Diskin v. Lomasney & Co., 452 F.2d 871, 876 (2d Cir. 1971), where this Court said: "Very likely Congress thought a better time for meaningful prospectus reading was at the time of the offer rather than in the context of a confirmation and demand for payment." Assuming the validity of this observation, it was addressed to a situation in which an underwriter (or at least a dealer) was offering a security to a customer who presumably knew nothing about the security other than what he had been told by the seller in connection with the latter's offer.

We are not dealing here with an "offer" to Faulkner, but with plaintiffs' response to an offer by Faulkner, published in the Pink Sheets, to buy stock of White Shield. In Point I of our principal brief we observed (p. 23) that the Commission has always recognized that the market-maker in such a situation is not an offeree, cf., Rule 154, 17 CFR § 230.154, and Judge Werker agreed, CCH Sec.L.Rep. p. 99,345 (A-11).

Thus, even if the "right" espoused by the Fifth Defense could be justified on facts akin to those in Diskin, it has no application on the facts of the present case. Furthermore, to recognize such a "right" in the case of a market-maker would be inconsistent with Rule 15c2-11(1), 17 CFR § 240.15c2-11(1), which now requires a broker-dealer to have in his possession a copy of the final prospectus before inserting bids in the Pink Sheets for a security which is in registration.

The Fifth Affirmative Defense is sham, and the decision of the Court below granting summary judgment to plaintiffs thereon should be affirmed.

POINT III
(Answer to Faulkner's Point VII)

THE COURT BELOW PROPERLY GRANTED SUMMARY JUDGMENT TO PLAINTIFFS ON FAULKNER'S NINTH AFFIRMATIVE DEFENSE BECAUSE PLAINTIFFS, NOT BEING NASD MEMBERS, ARE NOT GOVERNED BY ITS RULES

In its Ninth Affirmative Defense, Faulkner complains that in reselling for plaintiffs the stock rejected by Faulkner, Tobey & Kirk allegedly did not comply with the Uniform Practice Code of the National Association of Securities Dealers, Inc., by failing to give to Faulkner a "notice of sell-out" in conformity with NASD Rule 60(b) and by not selling out the rejected stock in conformity with NASD Rule 52(b). Judge Werker rejected the defense both because the NASD Rules are inapplicable to plaintiffs, who are not members of the NASD; and also because the NASD rules are permissive, and not mandatory.

Putting aside the question of how Faulkner has been damaged by the failure to receive a *pro forma* document informing it that Tobey & Kirk or its customers did not acquiesce in its unilateral cancellation of the contract, it is clear that Judge Werker's rationale is correct. The Uniform Rules of the NASD are designed to facilitate proper matching of rejected securities with resales in situations involving disputes between brokers as such, where the selling broker has paid the purchase price to his own customer and is himself out of pocket. Such a broker may have a great deal of fungible stock so that some form of identification and notification is necessary.

Here the dispute is between a purchaser and seller, not between brokers as such. The original sale was indisputably negotiated between Faulkner's trader MacMillen and plaintiff Santangelo, with Tobey & Kirk entering to "make the sale" only after the principals had agreed on its terms. The nature of the transaction was such that Tobey & Kirk did not remit the proceeds of the cancelled sale to plaintiffs, so that it was plaintiffs, and not Tobey & Kirk, who were out of pocket.

Moreover, plaintiffs could have held the securities for Faulkner's account under UCC 8-107(2) and sued for the contract price, in which case the inapplicability of the NASD Rules would be manifest. The inapplicability of the NASD Rules is no less manifest merely because plaintiffs elected to resell, and used Tobey & Kirk to do so. They were entitled to resell through Tobey & Kirk, or through another broker (as Faulkner recognizes,

Brief, p. 107), or even without benefit of a broker, and in none of these situations do the NASD Rules apply.

If Faulkner claims to have sustained any prejudice or damage by reason of Tobey & Kirk's putative failure to comply with its obligations under the NASD Rules, its remedy is by way of a third-party claim against Tobey & Kirk to indemnify it for any loss resulting from such alleged violations by Tobey & Kirk, not by way of a defense to plaintiffs' suit. The fact that Tobey & Kirk is no longer in business and is therefore unable to respond to Faulkner's claim for indemnification does not convert such claim against Tobey & Kirk into a valid defense to plaintiffs' suit against Faulkner.

The Ninth Affirmative Defense is specious and lacks merit. The Court below properly granted judgment to plaintiffs thereon, and its decision should be affirmed.

POINT IV
(Answer to Faulkner's Point IX)

THE COURT BELOW PROPERLY GRANTED SUMMARY JUDGMENT TO PLAINTIFFS, DISMISSING FAULKNER'S SECOND AND THIRD COUNTERCLAIMS FOR COMPENSATORY AND PUNITIVE DAMAGES

Faulkner's Second and Third Counterclaims seek recovery of $1,875 as compensatory damages, and $1,000,000 as punitive damages. The only difference between the two counterclaims is that the Second Counterclaim charges a violation of Rule 10b-6, while the Third Counterclaim claims a violation of Rule 10b-5. Judge Werker dismissed the Second Counterclaim because he found

Rule 10b-6 had not been violated. On reargument he dismissed the Third Counterclaim, apparently because of the absence of cognizable damage. The dismissal of the two counterclaims should be affirmed.

Apart from the merits of Faulkner's claim of alleged wrongdoing, the two counterclaims are non-maintainable because Faulkner sustained no damages cognizable under the Exchange Act. However it now characterizes its damages, Faulkner manifestly seeks to recover the profit it would have made on a resale of a portion of the stock purchased from plaintiffs. Moreover, a suit under the Exchange Act precludes the recovery of greater damages under the guise of "pendent" state claims.

(a) Faulkner has Sustained No Damages Cognizable under the Exchange Act

Section 28(a) of the Exchange Act, 15 U.S.C. § 78bb(a), provides in pertinent part that

> "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of."

This provision manifestly requires the dismissal of Faulkner's claim for punitive damages insofar as it purports to be brought under the Exchange Act. Globus v. Law Research Service, Inc., 418 F.2d 1276, 1283-87 (2d Cir. 1969).

Moreover, in the case of allegedly defrauded purchasers, section 28(a) has consistently been construed to foreclose recovery

of the loss of anticipated profits. As stated by this Court in Levine v. Seilon, Inc., 439 F.2d 328, 334 (2d Cir. 1971):

> ". . . the complaint says quite clearly that Levine's intention was to hold the shares and tender them to the company, and he wants the benefit he might thus have realized. The rule of damages applicable under the Securities Exchange Act does not entitle him to recover on any such basis."

Accord, Estate Counselling Service v. Merrill, Lynch, 303 F.2d 527, 533 (10th Cir. 1962); Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965); Madigan, Inc. v. Goodman, 498 F.2d 233, 239-40 (7th Cir. 1974).

The undisputed facts in the present case are that Faulkner purchased 44,000 shares of White Shield stock at $14 per share, and immediately resold 20,000 of those shares. Its paper profit on the resale of those 20,000 shares was $1,875. Allegedly upon learning of the putative violation of Rule 10b-6 it purported to cancel its purchase from plaintiffs and obtained the agreement of its own vendees to the cancellation of the resales, without penalty. It now sues to recover as its compensatory damages the sum of $1,875---which is the precise amount of the profit it would have obtained on the resale of 20,000 shares. On authority of the above-cited decisions, Faulkner's lost profit is not recoverable as "actual damages" under the Exchange Act.

Moreover, since Faulkner's contract with plaintiffs was a unitary contract for the purchase of 44,000 shares, it cannot be permitted to claim the right to recover its loss of the tiny profit on the resale of 20,000 of those shares without taking

into account the much larger paper loss on the remaining 24,000 shares which it would have sustained had it not cancelled the purchase from plaintiffs and the resales. It is stipulated that at no time after the cancellations on June 15, 1971 was the market price of White Shield stock at or above Faulkner's purchase price of $14 per share (A-108-10). In a different context Faulkner states that by the time of the settlement "the price had only declined from $14 to $12.34" (Brief, p. 19), which would give it a paper loss on the unsold 24,000 shares of $39,840, or a net loss on the overall 44,000 share transaction of $37,965. On no theory, therefore, can Faulkner be permitted to ignore the unitary character of its purchase from plaintiffs, and recover only on that portion of the transaction which would have resulted in a small profit to itself.

Finally, the putative "loss" is not chargeable to plaintiffs. Even if, *arguendo*, *Jaffee* required Faulkner to cancel its purchase from plaintiffs, *Jaffee* could on no theory be extended to make unlawful Faulkner's own sales of 20,000 shares to Singer & Mackie and Mitchum, Jones & Templeton, which sales it could have covered in the open market. As Faulkner has recognized (A-454), had it made open-market purchases to cover its short position resulting from the cancellation of its purchase from plaintiffs, it would have realized a $32,000 profit. This being the case, Faulkner concocts an elaborate extension of the *Jaffee* principle: It says (A-455) that "the entire Tobey & Kirk transaction was unlawful, *including the portion placed with Singer and*

Mitchum" (emphasis added). From this conclusion it argues further, ibid, that since

> "Tobey & Kirk was effecting a distribution of registered White Shield stock through several market-makers, thus depressing the price of the stock . . . [and since] there were other large blocks of White Shield stock being distributed at the same time . . . had Faulkner attempted to cover the resales by purchasing stock in the open market, not only would Faulkner's profit have been the result of an illegal transaction but Faulkner would very likely have participated in an illegal distribution, since by covering the resales with the stock involved in the distribution, it would have been acting as a conduit in effecting a distribution through the two market-makers to whom the resales had been made." (Emphasis added).

While there is no basis in Jaffee for Faulkner's conclusions, or for extending the reach of that decision to require all market-makers to get out of the market whenever there is a registered offering (since, in the normal course some of them would necessarily be purchasing registered stock at some point), Faulkner's contentions do underscore the contrived nature of its Rule 10b-6 and Rule 10b-5 defenses.*

Faulkner suggests (Brief, p. 124), that its claim for $1,875 is based upon its out-of-pocket expenses, including "postage, handling and telephone expenditures in anticipation of de-

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*It would follow from the foregoing contention that plaintiffs' alleged omission to disclose that their own stock was in registration is only the visible part of the iceberg of alleged non-disclosure: On Faulkner's expansion of Jaffee, it would seem manifest that plaintiffs would have been obliged to inform Faulkner that there would be four registrations of White Shield stock and that there "were other large blocks of stock being distributed at that time," something which is actually disclosed in each of the four prospectuses, and itself confirms our view that Faulkner had an independent obligation as a market-maker to ascertain the status of securities in which it was making a market.

livery and also expenses of a similar nature necessitated by the cancellation of the purchase and resales." However, all the parties are located in New York City, so that any such expenses are at best de minimis, and could in no event approach the $1,875 claimed as damages. Even were there any such damages, Faulkner failed to document them as required by FRCP 56(e), and cannot complain if summary judgment dismissing the counterclaims was granted to plaintiffs.

Faulkner has no colorable claim for damages under the Exchange Act, and the Court below correctly dismissed the Second and Third Counterclaims. Since the subject matter jurisdiction of the Court below now rests solely upon the substantiality of Faulkner's two counterclaims, their patent lack of merit and the consequent effect on the Court's subject matter jurisdiction to proceed, it was jurisdiction and not a putative desire to disqualify Judge Gurfein (Faulkner's Brief, pp. 63-64, nt.), that led us to appeal his dismissal of the complaint.

(b) The damages claimed by the Second and Third Counterclaims cannot be recovered as allegedly pendent state claims

Faulkner attempts to justify its claims of damages as being recoverable under its allegedly pendent state claim for common law fraud and under New York General Business Law § 352-c. The contention is untenable.

Punitive damages are not recoverable in New York for ordinary fraud, but only in situations in which a defendant has

engaged in a conscious and deliberate scheme to fleece the public, cf., Walker v. Sheldon, 10 N.Y.2d 401, 405-06 (1961), or has resorted to physical violence, I.H.P. Corp. v. 210 Central Park South Corp., 12 N.Y.2d 329, 333-34 (1963). Any "fraud" with which plaintiffs could be charged herein would not qualify for an exemplary recovery under New York law: The most with which plaintiffs can be charged is that they did not know the Jaffee Rule, did not understand the thrust of Faulkner's traders' questions, and thus may have given responses to Faulkner's traders which this Court might hold were insufficient.

Nor can punitive or compensatory damages be imposed on plaintiff under state law on account of alleged market manipulation, because the market was simply not manipulated by plaintiffs (or, seemingly, by anyone else), even if it be held that the transaction in suit violated an unprecedented extension of the federal anti-manipulation rule.

This fact underscores the more difficult conceptual question: whether state law can provide any remedy---whether the allegedly wrongful act is labeled common law fraud or a violation of section 352-c---for what is indisputably an alleged violation of the Exchange Act. The question arises because section 27 of the Exchange Act, 15 U.S.C. § 78aa, gives federal courts

> ". . . exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits . . . brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder," (Emphasis added),

and section 28(a) adds that

> "no person permitted to maintain a suit for damages under . . . this chapter shall recover . . . in one or more actions, a total amount in excess of his actual damages on account of the act complained of." (Emphasis added).

On its face this is a limitation on the total recovery "on account of the acts complained of," and cannot properly be avoided merely because "the acts complained of" are alleged also to violate some state rule or statute. If larger damages are recoverable under the state law, it would seem that a party who chooses to sue "to enforce any liability or duty" under the Exchange Act, must forego any greater recovery under state law "on account of the acts complained of," or sue in state court and forego the presumed benefits of the Exchange Act. The "acts complained of" in this action arise out of and relate solely to a purely federal rule having no analogue in state law. Any recovery, however characterized, will be to vindicate the alleged violation of that federal rule.

We realize that in Flaks v. Koegel, 504 F.2d 702 (2d Cir. 1974), this Court joined the growing number of courts which have permitted the joinder of pendent claims for punitive damages. However, judicial convenience and economy are not the only interests required to be served in federal litigation, and it may perhaps not have been sufficiently stressed that such holdings do violence to the limitations imposed by Congress. Flaks v. Koegel, and the other cases permitting joinder of pendent claims for punitive damages must be re-examined to determine whether the

allegedly pendent claims really assert independent but related state law claims, or were impermissible evasions of the limitations of section 28(a).

Faulkner itself appears to have recognized this limiting principle: In the state court Faulkner pleaded nine affirmative defenses but no counterclaims. It was evidently clear to Faulkner that it could not counterclaim in the state court for an express violation of Rules 10b-6 or 10b-5 because of section 27 of the Exchange Act. Given the numerosity and inventiveness of its defenses, its failure to counterclaim in state court for the alleged violations of GBL § 352-c or for common law fraud can scarcely be ascribed to the carelessness of its counsel, and attests to their own realization that Faulkner could not counterclaim under state law for what were essentially federal violations.

However, once plaintiffs commenced their federal action, Faulkner augmented the same nine defenses with two counterclaims explicitly invoking both Rules 10b-6 and 10b-5 and the allegedly pendent claims for common law fraud and for violation of GBL § 352-c, seeking $1,000,000 in punitive damages on top of a speculative $1,875 in compensatory damages. Even so, Faulkner's effort to justify these damages on the ostensibly pendent state law claims for relief did not even begin until after plaintiffs had moved to dismiss the Second and Third Counterclaims because they were not maintainable under the Exchange Act.

Faulkner's Second and Third Counterclaims are legally insufficient and Judge Werker was correct in dismissing them. His decision thereon should be affirmed.

POINT V
(Reply to Faulkner's Point I)

FAULKNER'S EFFORT TO DEMONSTRATE THAT PLAINTIFFS VIOLATED RULE 10b-5 MISSTATES THE FACTS OF RECORD AND THE TESTIMONY OF THE PARTIES

Faulkner makes a two-fold response to our showing that its First Affirmative Defense is insufficient. In the first place it simply mischaracterizes the testimony. Secondly, it ignores the recent authorities we cited in Point IV of our Brief, beyond saying that they are inapplicable or refute plaintiffs' contentions (Brief, p. 23).

A. As to the Conversations Leading to the June 7 Trade

The essential thrust of Faulkner's Rule 10b-5 contention, which now can be most generously characterized as disingenuous, is that Santangelo allegedly denied that his stock was part of "any secondary". In our original brief we reviewed the testimony on that contention, showing that MacMillen's testimony refuted Faulkner's contention and that Lattuga's testimony that Santangelo had used the word "any" was withdrawn by him when he was confronted with the traders' contemporaneous memorandum (A-450-51), which confirmed that the definite article had actually been employed.*

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*Actually, Lattuga's first two unguarded testimonial references to his conversations with Santangelo used the definite article (A-358, 361-62). Evidently remembering the significance of the indefinite article, his next two paraphrases of his question employed "any" (A-362, 368). Then followed the production of the memorandum, and Lattuga's certainty as to "any" vanished.

In its Brief Faulkner says (p. 13),

> "Lattuga testified that he asked Santangelo whether the stock being offered to Faulkner was part of 'the' or 'any' secondary, and Santangelo replied that it was not,"

and adds that Lattuga claims never to have mentioned the Leason secondary himself.* What Faulkner is trying to suggest is that Lattuga had asked Santangelo: "Is this stock part of <u>the</u> secondary, <u>or</u> <u>any</u> secondary?" and that Santangelo said, "No." However, Faulkner's Brief perverts the actual testimony, and the transcript of Lattuga's testimony makes clear that that is not how the actual conversation between him and Santangelo went.

At Lattuga's resumed deposition, the following colloquy occurred (A-371-72), which Faulkner misdescribes in supporting its claim that Santangelo lied:

> "Q Is it your testimony that in describing the status of his stock Mr. Santangelo told you that it was not part of any distribution?
>
> "A The word 'any' also could have been the word 'the', (spelling) t-h-e.
>
> * * *
>
> "Q What was the precise question you asked Mr. Santangelo with reference to whether or not this was clean stock?
>
> * * *
>
> "A I asked if it was clean stock and part of <u>any</u>, or <u>the</u>, secondary--<u>I couldn't be 100 percent sure which word I used</u>--and he said, no, it was not part of <u>the</u> secondary.

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*As in the case of "the" or "any," Lattuga first testified (A-361-62) that it was he who first mentioned the Leason secondary, but almost immediately afterwards he stated he had not mentioned it. <u>Ibid</u>.

"Q I did hear the preposition [sic] 'the'.

"A He said, no, it was not part of the secondary." (Emphasis added).

Thus Faulkner's description of the testimony is deliberately misleading in its effort to suggest that Lattuga had asked Santangelo whether the stock was "part of 'the' or 'any' secondary." The evidence is unequivocal that no question ever put to Santangelo contained the alternative language upon which the accusation of misrepresentation depends. Rather, the alternative language reflects the testimonial uncertainty of the witness as to which question he had asked, it was not part of the question itself. Even so, the testimony left no doubt as to Santangelo's answer: Lattuga concedes that Santangelo said that his stock was not part of "the" secondary, which answer itself suggests that the question had used the definite article, and conforms to MacMillen's testimony, to the Faulkner traders' contemporaneous memorandum, and to the fact that the Faulkner traders only knew of one secondary and so would be most unlikely to be inquiring about other, hypothetical secondaries.

Santangelo was asked and truthfully responded that his stock was not part of the Leason secondary. Faulkner's efforts to obscure this fact should be rejected.

B. As to the Conversation between Lattuga and Ross

Faulkner evinces much the same disregard for the facts in suggesting that in a conversation after the sale but before the settlement date Ross had lied to Lattuga by denying that the

stock was registered. To demonstrate the full flavor of Faulkner's misleading characterizations of the testimony, we first quote the particular passage from its Brief (p. 15):

> "Lattuga testified that after the trade he heard that Tobey & Kirk was selling White Shield stock 'all over the street' and called Tobey & Kirk on June 14, 1971, the day prior to the settlement date, _to determine whether the shares Faulkner had purchased were part of a secondary_; that Vincent Ross said 'no', they were part of an 'uncoordinated wraparound secondary'; that Lattuga asked Ross what that meant, to which Ross replied he didn't know; that Lattuga asked whether the stock would be accompanied by a prospectus; and that Ross replied 'no, but if you want one, I'll send it' (Lattuga Transcript, pp. 55, 78-9; A-386, 395-6). Ross admitted this conversation (Ross Transcript, pp. 103-4; A-248-9) and stated that he had been informed by the company (White Shield) that 'this was not a shelf registration . . . .'" (Emphasis added).

Lattuga testified as to this conversation twice. The first time he only paraphrased the conversation. The second time Lattuga directly quotes his own question and Ross's answer, and the direct quotation does not include mention of a "secondary." Indeed, when he was asked directly, _Lattuga explicitly denied having asked Ross about a secondary_.

Although Faulkner gives page citations to both excerpts from Lattuga's testimony, in its Brief it paraphrases only Lattuga's first testimony, in which he himself had only paraphrased his conversation with Ross (A-386-87):

> "A I had told him [Ross] that I had heard Tobey & Kirk was selling the stock all over the street and I wanted to know about the stock I had bought, _was it part of a secondary_.
>
> "Vin Ross said, 'no', it was an uncoordinated wrap-around secondary.

"I asked Vin what that meant, and he said he didn't know.

"I said when you deliver the stock will you send--does that come with a prospectus?

"He said, 'No, but if you want one I'll send it.'" (Emphasis added).

Later Lattuga was asked to be more specific as to what question he had actually asked, and he testified as follows (A-396-97):

"Q What did you say to Vin Ross?

"A I told Vin I had heard rumors that Tobey & Kirk was selling stock and I asked Vinnie about the stock that I had bought.

"Vin said that it was an uncoordinated wrap-around secondary. I asked Vin what that meant. He said he had no idea, and I asked him, 'Vin, does this come with a prospectus?'

"He said, 'No, but if you want one you can have it.'

* * *

"Q <u>Did you ask Vin Ross specifically if these shares which you had purchased were part of a secondary, the secondary, or any secondary</u>? <u>Did you ask him that question at that time</u>?

"A <u>No, sir</u>. <u>It was more like, 'Vinnie, the shares I bought, Vin, what were they</u>?'

"That's when he volunteered the uncoordinated." (Emphasis supplied).

Thus Lattuga's effort to quote the precise question he had asked Ross contains no reference to "registered stock," and, moreover, he concedes that Ross "<u>volunteered</u> the uncoordinated," so that that the information was not coaxed out of him after a putative denial that the stock comes with a prospectus, as Lattuga earlier tried to suggest.

Moreover, on both occasions Lattuga claims to have called Ross about a rumor that Tobey & Kirk was "selling stock" or "selling the stock", without any modifier, whereas it is clear that the fact that a broker-dealer was selling stock would be unremarkable. MacMillen had testified that the rumor had concerned "unregistered stock," and before the production of the traders' contemporaneous memorandum Lattuga said he called about a rumor concerning "registered stock." Now he pulls back to "selling stock" or "selling the stock" which in and of itself speaks volumes.

Given MacMillen's testimony (A-267-68, 288, 295-96), and the traders' contemporaneous memorandum (A-450-51), it is clear that Lattuga called Ross about a rumor involving sales of <u>unregistered</u> stock. Then, in response to that inquiry, Ross told him "No, [it was not unregistered stock], it was an uncoordinated wrap-around secondary." Moreover, it is clear that whether or not Lattuga had actually used the word "unregistered", in these circumstances he neither had any occasion to use, nor did he use, the term "registered."

Nor is Faulkner's Brief accurate when it says that Ross's testimony confirms Faulkner's version of the conversations. Ross was testifying to a conversation which necessarily occurred after Faulkner already had a copy of the prospectus (A-248-49):

> "A Somebody, whoever it was, at Faulkner, called one evening around six or nine o'clock, or six-thirty, <u>with some questions on the prospectus, they were going over it</u>.

"Q Do you recall what the questions were?

"A Well, they were questioning whether it was a shelf registration or secondary and they wanted to know exactly what the situation was.

"Q What do you understand by the term 'shelf registration?'

"A I had been informed by the company that this was not a shelf registration, but technically this was a sort of special situation which was defined as an uncoordinated wraparound registration of securities." (Emphasis added).

In this connection, it should be noted that Lattuga himself had only the vaguest notion of the meaning of "shelf registration" as is demonstrated by the following colloquy (A-384-85):

"Q Is it your understanding that shelf stock is unregistered stock?

"A That I don't know, sir."

Neither "shelf registration" (or secondary) nor "uncoordinated wraparound registration" (or secondary) is defined in the Act or the regulations. Both are part of the jargon of SEC lawyers, and Faulkner repeatedly apologizes for its traders, whom it describes as unsophisticated (Brief, p. 95 nt.)*. If MacMillen and Lattuga are laymen so also is Ross. But whereas Ross could not be expected to infer from Lattuga's apparently admitted use of the

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*Of MacMillen, Faulkner states (Brief, p. 14) that he "is a layman and had only a very general understanding of the legal terminology of the securities laws." Of Lattuga it says, id., p. 16, that "he did not use the term 'unregistered' in its legal sense, but meant by the term stock which Faulkner could not lawfully sell [sic; buy?]" (while in the next breath stating that the contemporaneous memorandum was inaccurate in attesting to Lattuga's use of the term "unregistered").

word "unregistered" that he meant its antonym "registered," Faulkner criticizes Ross because, allegedly in response to a question using the obscure term "shelf registration," his answer was qualified by another obscure term, "uncoordinated wrap-around registration," which is its synonym.

Seeking to explain MacMillen's admission that Santangelo told him the stock was registered, Faulkner says (p. 15, nt.) that

> "MacMillen had testified that Santangelo had told him, prior to the trade that Santangelo had some registered stock, but the stock being sold to Faulkner was not part of the registered stock . . . and that it was owned by another group that he belonged to . . .,"

adding that the existence of the unidentified "group" made Faulkner's failure to obtain the prospectus irrelevant. Again Faulkner ignores the actual testimony.*

Finally, Faulkner asks (Brief, p. 16):

> "If, as plaintiffs contend, Faulkner's traders had been informed prior to the trade on June 7 that the stock being offered was part of the secondary distribution, why would Lattuga have telephoned Ross after the trade to ask this question?"

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*MacMillen asked Santangelo whether the stock was part of the "Leason secondary" (Principal Brief, p. 74), and was told that "this is stock in another group," i.e., another secondary. MacMillen evidently misunderstood, but had he looked at the prospectus he would have learned (A-139) that Santangelo owned of record and beneficially only 30,800 shares not part of the registered distribution. Had MacMillen asked the identity of the "group's" members, he would have learned that it included Byrnes and Draddy (who were offering all their stock by the prospectus), and Pedersen (who was offering all but 5,042 shares by the prospectus), so that the "group" owned only 35,842 shares not part of the registered distribution, which is less than the 44,000 shares he was contracting to buy.

There are several possible explanations: The first, suggested by Ross's testimony (ante, pp. 47-48), is that the telephone call to Ross was made after Lattuga received the stock and the prospectus, and was understandably confused because of his preconceptions and assumptions. Another alternative is that Lattuga called and asked about "unregistered stock," in which case there is no element of duplication or repetition. Finally, before the sale the Faulkner traders admittedly asked Santangelo daily whether his stock was "good, clean stock," (another term not found in the statute), and although repeatedly reassured it was, kept asking the same question (A-266, 268, 279, 287, 362). Thus, if there were repeated inquiries, it was because the Faulkner traders believed that they complied with the securities laws by "going through the motions" (MacMillen Dep., A-274, 278, 343, Tr. 77, 109-10).

Plaintiffs respectfully submit that there is no substance to the allegations of violations of Rule 10b-5, based upon the matters discussed by Faulkner in subpoint B of its Point I.

C. Faulkner's Observations as to the Credibility of the Participants to the Conversations are Irrelevant

Faulkner states the obvious when it says (Brief, p. 17), that "the Court cannot assess the credibility of witnesses on a summary judgment motion," it then invokes only those portions of Lattuga's testimony which support Faulkner's counsel's theory that Santangelo and Ross actually did misrepresent the facts, and

ignoring the testimony of MacMillen, the contemporaneous memorandum of both traders, and also the more explicit portions of Lattuga's own testimony. In reality there is no factual dispute.

Faulkner next states (Brief, p. 18) that "the entire record shows an agreement by Faulkner to purchase freely tradeable stock, and that it was not informed that the stock it had agreed to purchase was part of a registered distribution." Yet although the record clearly shows that plaintiffs disclosed the registered character of their stock, it is wholly silent as to any communication by Faulkner to plaintiffs or Tobey & Kirk that its offer to purchase excluded stock in a registered distribution (assuming that is what it means by "freely tradeable stock"). Faulkner thus advocates a curious double standard: While charging plaintiffs with violating Rule 10b-5 by failing to disclose in unmistakeable terms facts already disclosed in a prospectus with which the Faulkner traders appeared to be familiar, Faulkner seeks to import as one of the terms of the contract of sale a condition which only a securities lawyer could be expected to know---that its offer to purchase White Shield stock was limited only to stock which was not in registration.

At page 19 Faulkner scoffs at the suggestion that it had any motive other than its devotion to the law for cancelling the contract, observing that because the market price of White Shield stock had dropped only to $12.34, "performance of the contract would not have had a substantial economic consequence to Faulkner." As we have shown above (p. 36), Faulkner had a net

paper loss of $37,965 on its purchase and resales, which was incentive enough to cancel a contract for trumped up reasons. Faulkner's putative concern for its reputation based upon "unjustifiably cancelling a contract" (Brief, p. 19) deserves no comment beyond noting that its concern for its "reputation" evidently was not great enough to cause Mr. Green to review the legal basis on which he cancelled the contract with plaintiffs.

Faulkner argues (ibid.) that the Record does not support our contention that its willingness to reconsider its cancellation "vacillated with the market prices of the stock." But while the Stipulation itself does not disclose the vacillations, Faulkner's house counsel, Marc R. Green, himself admitted that as late as June 21, 1971 "Faulkner was prepared at that time to consider possible avenues of accepting the stock" (A-415). However, that was before the market break following the press release of June 22, 1971, which led to Green's "final" conclusion that the transaction was "illegal" on June 23, 1971.

In a footnote at page 20 of its Brief, Faulkner states that "Plaintiffs' purported ignorance of the law is not a valid justification for any of the violations of the federal securities laws in which they participated," an argument which misses the mark: If plaintiffs had in fact violated Rule 10b-6 by making open-market purchases while still participating in the distribution, their putative ignorance of the law would be no defense, a proposition for which Jaffee & Co. v. SEC, 446 F.2d 387, 391-92 (2d Cir. 1971), may properly be cited. But plaintiffs' ignorance of the Jaffee rule is pertinent to a determination of whether or

not their answers to the questions put by the Faulkner traders had the requisite scienter upon which to base a claim of violation of Rule 10b-5, which is what is being considered in Point I of Faulkner's brief.

D-E. On the Duty of Inquiry and Applicable Legal Standards

Faulkner argues at page 23 that plaintiffs "were well aware of the two facts which would have made consummation of the sale illegal---Faulkner's status as a market-maker and the fact that plaintiffs were tendering distribution stock." But there is no evidence whatever that either plaintiff knew the legal conclusion which tied the two "facts" together or even the fact that Faulkner was a market-maker. Santangelo specifically testified that he did not know that fact (A-183-84). Moreover, while plaintiffs obviously knew that their own stock was registered, they did not know its relevance to Faulkner or that Faulkner did not have the White Shield prospectuses. In any event Santangelo did disclose his stock was in registration (A-340-41).

As to disclosures concerning the illegality of the transaction, their putative "illegality" must await this Court's deicision, and both Judge Werker's decision below and the Commission's decision in Collins undercut Faulkner's assumption that the sale of registered stock to a market-maker was illegal per se. Any disclosure that the sale was, or might be, illegal, if required at all, would have had to be greatly qualified or

circumscribed. cf., TSC Industries, Inc. v. Northway, Inc., ___ U.S. ___, 48 L.ed.2d 757, 768-69 (1976). Even if this Court were to reverse the holding of the Court below insofar as it granted plaintiffs summary judgment on the Fourth Defense, that would scarcely alter the fact that the alleged "illegality" was not a "fact", material or otherwise, but a "conclusion of law," and a debatable one at that. Cf., Vons v. Dickson, 495 F.2d 607, 625 (5th Cir. 1974).

Faulkner cites misrepresentation cases like MGM, Inc. v. Ross, 509 F.2d 930, 933 (2d Cir. 1975), and Dale v. Rosenfeld, 229 F.2d 855, 858 (2d Cir. 1956), but the facts of those cases have no application to the case at Bar. In Dale v. Rosenfeld, the prospectus itself actually misrepresented the terms of the underwriting agreement. All that this Court held was that an invitation in the prospectus to examine the non-annexed underwriting agreement did not satisfy the duty of disclosure.

In MGM v. Ross, the sellers had affirmatively misrepresented the state of their accounts receivable and their policy on sales returns and free samples. This Court held that the possibility of the buyer's discovering the truth by analyzing computerized inventory cards furnished by the sellers did not relieve the sellers from the consequences of having misrepresented the facts, particularly since the agreement of sale required the sellers to make specific disclosures and warranties.

These cases are inapplicable here because they hold that a seller must disclose material non-public facts pertaining

to the seller or its business, where there is no reason for the seller to assume that the buyer has knowledge of those facts, but knows they are likely to be material to the buyer. Faulkner seeks to apply those principles in a situation which would require a seller to disclose to the buyer publicly-available facts primarily relating to or concerning the buyer's business, cf., Gruss v. Curtis Publ. Co., 534 F.2d 1396, 1403 (2d Cir. 1976), where the seller has no reason to believe that those facts are both unknown to the buyer and important to him. While carping about a return to caveat emptor, Faulkner's approach would make anyone dealing with a market-maker an insurer of the market-maker's honesty since the seller could never know what the market-maker will claim, after the event, was material to it and omitted.

Here, in fact, all the material facts which Faulkner claims to have needed were actually disclosed in the prospectus covering plaintiffs' shares, and plaintiffs concededly were not required to deliver a prospectus prior to the sale on June 7, 1971. Moreover, the conversations between the principals prior to the sale were carried on in circumstances which suggested to plaintiffs that the Faulkner traders were well acquainted with White Shield's public offerings, as they should have been, so there appeared to be no need to disclose details concerning the four secondaries. Nevertheless, it is admitted that Santangelo informed MacMillen that his name appeared in a prospectus as a selling shareholder. When Faulkner's traders made inquiries about one specific secondary, the Leason secondary, those inquir-

ies were truthfully answered, as was Lattuga's inquiry about "unregistered stock." Plaintiffs were under no obligation to substitute for the direct questions actually put to them their own assumptions as to what the Faulkner traders should have been asking, or were trying to ask, or to answer questions which were not asked.

Despite the seemingly easier test for liability under section 12(2) of the Securities Act, which is not even invoked in the First Defense, Faulkner's belated effort to invoke that section also must fail. Under section 12(2) there must still be an untruth, or an omission which rendered actual disclosures misleading, and the seller's disregard for or lack of care in ascertaining the truth. Moreover, the purchaser's knowledge of the facts is a defense.

F. As to the Failure to Disclose that Tobey & Kirk was an Underwriter

We have already considered in Point III of our principal Brief Faulkner's suggestion that the prospectus violated the Securities Act by failing to disclose the legal conclusion that Tobey & Kirk was (or might be deemed) to be an underwriter under the Securities Act. Faulkner's insistence on importing that same alleged violation into its Rule 10b-5 defense is unhelpful: If it cannot prevail on its Third Defense under the Securities Act, *a fortiori* it cannot prevail on the same theory under Rule 10b-5 because of the *scienter* requirement thereunder.

The only thing new that has been added, (and it is also added in Faulkner's discussion of the Third Defense where it is

equally inapposite), is the suggestion that the prospectus omitted to state the conclusion that Tobey & Kirk was also an underwriter under Rule 10b-6(c)(1). But that is not the failure to disclose a material fact under either statute. Rule 10b-6 defines the term "underwriter" for purposes of that Rule as a predicate for forbidding such persons to bid for or purchase stock for their own accounts while participating in the distribution. Since Tobey & Kirk made no such purchases, the fact that it might arguendo qualify under Rule 10b-6(c)(1) as an "underwriter" is as irrelevant as its membership in the AMEX, and the failure to disclose it is not the omission of a material fact.

G. As to the Alleged Failure to Disclose the Method of Distribution

Equally ill-considered is Faulkner's suggestion that plaintiffs violated Rule 10b-5 by failing to disclose to Faulkner prior to the sale "that their stock was being sold to market-makers, which . . . constituted a manipulative distribution of the stock" (Brief, p. 27). Apart from the unwarranted conclusion of law as to the illegality of sales to market-makers, this contention simply ignores the fact that there was nothing to disclose.

The unarguable fact (A-165-66) is that the sale to Faulkner was plaintiffs' first sale, having been made almost immediately upon their receiving notification that the Commission had declared their registration statement effective (A-164-65, ¶¶ 4-8). Moreover, the initial call to Faulkner occurred not

because it was a market-maker but because Santangelo had been told by Ross that someone at Sherwood Securities Co. had told Ross that "Faulkner has a big interest in the stock---was a big buyer of the stock" (A-183), and Santangelo and Faulkner's Vanneck were "great friends."

All other sales of White Shield for plaintiffs' account were made after the sale to Faulkner and were handled solely by Tobey & Kirk (cf., A-101, # 5), and there was no "plan" to sell to market-makers. Byrnes had offered the stock to Havenfield Corp., not a market-maker (A-165, ¶ 6), and most of the shares actually sold were not sold to market-makers, especially if the sale to Faulkner be ignored (see, ante, p. 16).

Nor is there any showing that any sales to market-makers were illegal, even under Jaffee. Singer & Mackie's purchase from plaintiffs was made by it as agent (A-61, ¶ 72), and did not violate Rule 10b-6. Other market-makers could also have been buying as brokers, and since most of them bought small lots, could readily have resold the stock before making further purchases, thus avoiding a violation of Jaffee.

Finally, the only arguable materiality of the allegedly omitted information is that it might have had an effect on the market. Although we do not see how it could have had any effect, Faulkner has been remarkably inconsistent in its claims as to what effect it did have: At page 29 Faulkner says that plaintiffs' sales to market-makers and their "manipulation caused the market price for White Shield to be artificially inflated;" at page 123

it says their sales "caused or contributed to the price decline;" and in 1973 Faulkner's house counsel said that "Tobey & Kirk was effecting a distribution of registered White Shield stock through several other market-makers, thus depressing the market price of the stock." (A-455, ¶ 14). Yet the stipulated facts are (A-108-10) that the prices had been higher than the contract price of $14 per share before plaintiffs sold any stock to anyone; that MacMillen himself made the bid of $14 per share, which was a discount from the market price because of the size of the block (A-186-87, 245, 286); and that, with the exception of a single up-tick the day following the sale, the "high bid" price in the Pink Sheets declined below the sale price and never recovered (A-108-10).

There were no misrepresentations or omissions to state a material fact, and no violation of Rule 10b-5. The Court below erred in not granting summary judgment to plaintiffs dismissing Faulkner's First Affirmative Defense.

POINT VI
(Reply to Faulkner's Point II)

SECTION 2(10) OF THE SECURITIES ACT DOES NOT CONVERT A BROKERS' COMPARISON INTO A NON-COMPLIANT PROSPECTUS, AND THE COURT BELOW ERRED IN GRANTING SUMMARY JUDGMENT TO FAULKNER ON ITS SECOND AFFIRMATIVE DEFENSE

It is plaintiffs' contention that section 2(10) of the Securities Act was never intended to apply to the exchange of

brokers' "comparisons," so that, even though a "comparison" indubitably "confirms the sale of any security," it is not a "prospectus" under the Act despite section 2(10). Cf., Question and Answer # 8 in the General Counsel's Opinion (Plfs. Addendum, p. 117); Matter of Collins Securities Corp., supra, pp. 85,802-03 (id., pp. 142-43). Faulkner argues that our reliance upon the General Counsel's Opinion is "frivolous," and says (Brief, pp. 36-37), that the thrust of the Opinion is that

> ". . . a confirmation is a prospectus, but that a § 10(a) prospectus need not be delivered with a confirmation or with securities in an exempt transaction, whether that transaction be between a broker and his customer or a broker and a dealer. Plaintiffs' confusion results from their mistaken belief that the determination whether a communication is a prospectus depends upon whether the transaction is or is not exempt."

This contention is singularly devoid of logic. The Second Defense charges Tobey & Kirk with violating section 5(b)(1) by delivering a "prospectus" (the "comparison") which does not contain all the information required in a prospectus (and is not accompanied by one). The Second Defense does not turn on whether the transaction is or is not exempt but upon the use of a non-compliant "prospectus." On that theory, each of the writings considered in the General Counsel's Opinion, and the one in Collins, violate section 5(b)(1) because under section 2(10) they must be "prospectuses." Yet most of those writings were held by the General Counsel not required to be accompanied by a statutory prospectus, so there must be a different explanation.

We think the explanation is found in Judge Pollack's statement in Chris-Craft Industries, Inc. v. Piper Aircraft Corp.,

337 F.Supp. 1128, 1142 (S.D.N.Y. 1971), "The exemption from the prohibitions of the Rule, in a vital sense, defines the basic purposes of the Rule . . ." On this principle, if section 5 applies and no formal prospectus has been delivered, section 2(10) converts any writing which "offers" or "confirms" into a non-compliant prospectus to give teeth to section 5. However, if the transaction is exempt or section 5 does not require a prospectus to be delivered in the circumstances---to read section 2(10) as converting documents which offer or confirm the sale of a security into non-compliant prospectuses serves no statutory purpose and gives section 2(10) an independent substantive significance Congress obviously never intended: It made section 2(10) a definition rather than a prohibition, and later amended it to conform to the "settled interpretation" of the General Counsel's Opinion, including Question and Answer # 8.

Faulkner urges the Court to treat section 2(10) as an independent statutory mandate, but neither it nor the Court below could supply a reason for such a treatment other than the fact that section 2(10) literally includes any writing which "offers" or "confirms" the sale of a security. But that only begs the question because one consequence would be to require delivery of prospectuses even as to stock which is not part of the registered distribution. That is not required under section 5(b)(1), which forbids the transmission of "any [non-compliant] prospectus relating to any security with respect to which a registration statement has been filed," and so necessarily applies only to securities actually registered by the registration statement

and not to similar securities already part of the "float," cf., Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967). In contrast, if section 2(10) be read as a totally independent statutory mandate rather than as a definitional provision ancillary to section 5(b), it would apply to any writing which offers or confirms, whether or not a registration statement has been filed, and whether or not the registration statement registered the particular shares being offered or "confirmed."

In our discussion of the Second Defense we stressed that in some of the General Counsel's Questions and Answers, in which he held no statutory prospectus was required to be delivered, the confirmation or "comparison" unquestionably "confirmed" the sale of a security. From this we reasoned that the question is not whether a writing "confirms" a sale but whether the purposes of section 5(b)(1) are served by requiring the delivery of a prospectus with that writing. Accord, Matter of Collins Securities Corp., at pp. 85,802-03 (Plfs. Addendum, pp. 142-43). To us it seems clear that if a transaction is exempt from the registration and prospectus-delivery requirements of section 5(b), section 2(10) simply has no application. It is in that context that we focused upon Question and Answer # 8 in the General Counsel's Opinion, which so closely parallels the facts at Bar, for our conclusion that Congress had never intended to require that prospectuses accompany the exchange of inter-broker "comparisons."

Faulkner next argues that the transaction in suit was in no event exempt under section 4(1) because under section 2(12)

of the Securities Act Tobey & Kirk was a "dealer." We earlier noted (Principal Brief, p. 18, nt.), that section 2(12) only defines the term "dealer" in language which does not differentiate between "broker" and "dealer."

However, although the Securities Act does not separately define the term "broker" so as to distinguish it from "dealer," its substantive provisions, particularly sections 4(1) and 4(4), use the term "broker," explicitly or implicitly, and differentiate between the two functions. Thus, either the definitional section of the Securities Act must be augmented by importing the differentiations contained in the *in pari materia* sections 3(a)(4) and 3(a)(5) of the Exchange Act, 15 U.S.C. §§ 78c(a)(4) and (5), *cf.*, *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1283-87 (2d Cir. 1969), or the section 4(4) exemption must be read out of the Securities Act, and the section 4(1) exemption further limited to exempt only "transactions by any person other than an issuer, underwriter, dealer, or broker," since the term "dealer" includes "broker." We submit that less violence is done to the statutory scheme of the 1933 Act by importing into that Act the 1934 Act distinction between "brokers" and "dealers," than by judicially abolishing or eviscerating two statutory exemptions of section 4.

Next (Brief, p. 38), Faulkner attempts to distinguish Question # 8 of the General Counsel's Opinion by observing that John Doe in the hypothetical "had acquired his warrants in a registered offering by AT&T to its stockholders and sold them through his broker, [whereas] plaintiffs were themselves distribu-

ting stock in a registered offering." This is a distinction without a difference since both John Doe of the General Counsel's hypothetical Question # 8 and the plaintiffs could qualify under the definition of "underwriter" contained in section 2(11), since each could be held to have acquired securities from an issuer with a view to distribution (as Faulkner argues in its Third Defense). Thus, Faulkner's purported distinction is specious.

Insofar as Faulkner points (Brief pp. 38-39) to the fact that Questions and Answers ## 8 and 10 have been superseded by Rule 154 (Faulkner Addendum, pp. 22-27), the fact is that they were superseded in a manner which supports our original arguments. In our prior discussion of Questions and Answers ## 8 and 10 (Brief, pp. 22-25), we suggested that the section 4(1) exemption relating to "transactions by any person other than an issuer, underwriter, or dealer" was more appropriate and consonant with the Act as a whole than the section 4(4) rationale actually invoked, which explained our disagreement with the General Counsel's Answer to Question # 10. All Rule 153 did was to redefine the "unsolicited brokers' transaction exemption" of section 4(4) so as to make it inapplicable to Questions ## 8 and 10. That scarcely undercuts our prior argument, it confirms it. Those transactions should always have been exempt under section 4(1).

Faulkner's reliance upon and discussion of (Brief, pp. 39-40), United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968), and SEC v. Chinese Consolidated Benevolent Ass'n., 120 F.2d 738 (2d Cir. 1941), for the proposition that plaintiffs must prove

that they are not underwriters, completely misses the mark. Both cases dealt with the sale of <u>unregistered</u> stock, not with the question of whether a prospectus must be delivered at a specific time or with a specific document.

The issue here is not whether the transaction was actually exempt from registration, but whether the prospectus had to be delivered seven days before it actually was. The answer turns upon whether the purposes of section 5(b) are advanced by requiring that result, not upon the raw language of section 2(10). <u>Matter of Collins Securities Corp</u>., CCH Sec.L.Rep. ¶ 80,327, at pp. 85,802-03 (1975)(Plfs. Addendum, pp. 142-43).

Moreover, if one examines the statute as a whole, it is clear that the delivery of a prospectus is not required either with a confirmation or with a "comparison" if the buyer already has a copy of the prospectus.* In the case of a buyer who is a member of the general public and has been solicited to purchase by a dealer or underwriter, or even by a broker, the only way for a seller to assure compliance with the statute is to deliver a prospectus with the first writing which "offers or confirms." However, in the case of a purchaser who has himself solicited the sale from his broker---particularly where the purchaser is a dealer, or, <u>a fortiori</u>, a market-maker who is publishing his

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*The pre-existing statutory distinction---reflected in the General Counsel's Questions and Answers ## 3 and 5, which required delivery of a prospectus with a writing "which offers any security" regardless of whether or not the buyer already had a copy from another source, but did not require the delivery of a prospectus with the securities if the buyer had already obtained a prospectus elsewhere---was abolished by the amendments of 1954 (Plfs. Principal Brief, p. 14, nt.).

offers to purchase---the assumption can properly be made that he already has a prospectus. Cf., Gruss v. Curtis Publ. Co., 534 F.2d 1396, 1403 (2d Cir. 1976). In the case of market-makers that assumption is now reinforced by Rule 15cl-11(a) under the Exchange Act, 17 CFR § 240.15cl-11(a).

Faulkner says (Brief, pp. 41-42) that broker-dealers, like members of the public, are entitled to the protections of the Securities Act. That obviously is an overstatement and is contrary to the legislative history of the Act reviewed by Judge Werker, CCH Sec.L.Rep. ¶ 95,463 at p. 99,345 (A-11)(quoted in our Principal Brief, p. 34). No doubt, like other members of the investing public, brokers and dealers are entitled to be protected from fraud, A. T. Brod & Co. v. Perlow, 375 F.2d 393, 396 (2d Cir. 1967), but we are not dealing here with fraud, and it scarcely follows that brokers responding to published bids must assume that a market-maker is trading a security for its own account in total ignorance of publicly-available facts bearing upon the supply of the security and on the issuer's business.

Insofar as Faulkner attempts (Brief, p. 41), to import into the consideration of the meaning and applicability of section 2(10) factors derived from the New York Statute of Frauds contained in Uniform Commercial Code, § 8-318, that section is both inapplicable and mis-cited. Section 8-318 renders unenforceable a sale of securities unless one of four conditions is met. Faulkner invokes UCC § 8-318(c) for the premise that Tobey & Kirk or plaintiffs could not have enforced the contract had Tobey & Kirk not sent a "comparison" to Faulkner, thereby trying to tie the

transaction in suit to the language of Diskin v. Lomasney & Co., 452 F.2d 871 (2d Cir. 1971).

But, although UCC § 8-318(c) does provide an "account stated" rationale which would enable Tobey & Kirk to enforce a contract against Faulkner if Faulkner had kept the "comparison" and not objected to it, UCC § 8-318(a) would permit enforcement of the contract against Faulkner on the basis of Faulkner's having sent its own "comparison" to Tobey & Kirk, something which an ordinary purchaser of securities would not be required to do. Thus UCC § 8-318(a) reinforces our contention that "comparisons" between broker-dealers are different in principle from confirmations to customers.

Finally, Faulkner urges (Brief, pp. 41-42) that the reading given to section 2(10) by the Court below is necessary in order to enable the purchasing dealer to comply with his own independent obligation to deliver prospectuses to his own customers. As we have previously noted (Principal Brief, pp. 35-36), the delivery of a single copy of the prospectus with a "comparison," particularly with a large transaction like that in suit, will not measurably assist a market-maker in discharging his own duty to send copies of the prospectus with his confirmations to his own customers.

The inapplicability of section 2(10) to a broker's "comparison" is manifest from the 1941 General Counsel's Opinion. The fact that the Commission as amicus below urged a hyperliteral reading of section 2(10) to force it to apply to brokers' "compari-

sons" is scarcely compelling in light of its decision to the contrary in Matter of Collins Securities Corp, supra. Curiously, Judge Werker never even considered Collins on the section 2(10) issue, and Faulkner mentions it only en passent (Brief, p. 42).

The Court below erred in granting summary judgment to Faulkner on the Second Affirmative Defense, and that holding should be reversed with instructions to enter summary judgment for plaintiffs thereon.

POINT VII
(Answer and Reply to Faulkner's Point III)

THERE WAS NO OBLIGATION FOR THE PROSPECTUS TO MAKE GREATER DISCLOSURES RESPECTING TOBEY & KIRK'S PUTATIVE STATUS AS "UNDERWRITER," THE THIRD AFFIRMATIVE DEFENSE IS INSUFFICIENT AND THE COURT BELOW SHOULD HAVE GRANTED SUMMARY JUDGMENT TO PLAINTIFFS THEREON

In seeking reversal of the Court's refusal to grant summary judgment to plaintiffs on the Third Affirmative Defense, we argued that the failure of the prospectus to disclose, in terms, that Tobey & Kirk was an "underwriter" was not a violation of the Securities Act because (1) Plaintiffs themselves were not "underwriters," (2) Even if plaintiffs were "underwriters," Tobey & Kirk was not; and (3) Even if Tobey & Kirk were an "underwriter," the prospectus adequately disclosed the facts, and the failure to identify it is such by name was not a material omission, particularly given Faulkner's direct dealings with plaintiffs.

(a) Plaintiffs themselves were not "underwriters"

Faulkner begins by saying that plaintiffs have not proved that they themselves were not "underwriters." Citing cases like Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 690 (5th Cir. 1971); Gilligan, Will & Co. v. SEC, 267 F.2d 461, 466 (2d Cir. 1959); and SEC v. North American Research and Development Corp., 424 F.2d 63, 74 (2d Cir. 1970), it says that the burden of proof of an exemption from registration is upon the party claiming it, a position with which we do not argue, but one as irrelevant here as it was with respect to the Second Defense.

We stressed the unlikelihood of plaintiffs' themselves being "underwriters" not because they failed to register their shares or otherwise avoided registration, and notwithstanding that the prospectus itself says they may be "deemed" to be "underwriters," but solely as a predicate for showing that the alleged omission respecting Tobey & Kirk's putative status as underwriter was at best a doubtful legal conclusion, in circumstances in which the duty to disclose is not necessarily coextensive with the actuality of the underlying facts, cf., TSC Industries, Inc. v. Northway, Inc., ___ U.S. ___, 48 L.ed.2d 757, 768-69 (1976). Given the holding of TSC Industries, the actual prospectus disclosure respecting the status of brokers through whom sales were made amply suffices, a fortiori, since Faulkner dealt both with the plaintiffs themselves and with their broker.

Nor, in selling their own shares some three years after they acquired them do the plaintiffs become underwriters either for the issuer or for their original vendors. Their sale is for their own account and is not part of the distribution of anyone else. There is thus is no support for Faulkner's suggestion (Brief, p. 47) that because plaintiffs included their stock in a registration statement which also covered stock of others "plaintiffs and Tobey & Kirk became participants in the undertaking and the underwriting thereof, and accordingly, became underwriters." This is simply another instance of twisting statutory language.

(b) Tobey & Kirk was not an "underwriter"

Faulkner challenges our conclusion that even if plaintiffs are deemed to be underwriters, Tobey & Kirk is not an underwriter because it received only a normal broker's commission, by focusing on that portion of the Commission's definition in Rule 141(c), 17 CFR § 230.141(c), which excludes from the exemption

> "any person whose function is the management of the distribution of all or a substantial part of the particular issue, or who performs the functions normally performed by an underwriter or underwriting syndicate."

Having quoted the language, Faulkner states that "the functions [Tobey & Kirk] performed in connection with the distribution were in all respects equivalent to those of a 'best efforts' underwriter." This is sheer nonsense. Tobey & Kirk sold for plaintiffs only 6.4% of the stock being distributed, and it did so in competition with other brokers trying to get the best price for

their own customers, rather than as manager of a coordinated distribution (like the one in Matter of Jaffee & Co., supra).

Moreover, "best efforts" underwritings by their nature are generally "best efforts, all or none" (or some smaller threshhold), and if the issue is not sold out or the threshhold is not met, all subscriptions must be returned, which gives the underwriter an incentive to make a major selling effort to meet the prescribed threshhold, or he will receive nothing for his efforts. Cf., SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972). In contrast, Tobey & Kirk performed only a broker's function in selling plaintiffs' stock, selling what it could to whoever would buy it. Indeed, as respects the conversations with the Faulkner traders, Tobey & Kirk's role admittedly was purely formal: Prior to the sale all discussions were between plaintiff Santangelo himself, and either MacMillen or Lattuga.

Finally, Tobey & Kirk agreed to act for plaintiffs and to receive for its services only a normal stock exchange brokerage commission.* The exemption for the "usual and customary distributors' or sellers' commission" is designed, as Faulkner concedes (Brief, p. 50), to differentiate between those activities which require a major selling effort and those activities which are

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*As to the footnote on page 48 of Faulkner's Brief, in which it challenges Ross's testimony that the agreement to sell plaintiffs' shares was for normal Stock Exchange commissions (as reflected also in the prospectus, A-141), by noting that the testimony was given with respect to a sale to another market-maker, we note that necessarily no commission was paid to Tobey & Kirk on the sale to Faulkner because Faulkner cancelled the transaction when the stock was delivered.

similar to, if not identical with, normal brokerage transactions. If a broker-dealer is charging a selling shareholder his normal brokerage commission rate, he has neither the expectation nor the incentive to perform other than the normal brokerage functions, or to assume the heavy responsibilities or statutory liabilities of an underwriter.

(c) The omission to describe Tobey & Kirk by name as an "underwriter" was not material

Faulkner's major conceptual problem with its Third Defense is that the prospectus disclosures or putative omissions played no part whatever either in Faulkner's decision to purchase or in its decision to cancel the transaction with plaintiffs. This absence of any possibility that Faulkner might have been misled by the alleged omission, *ergo*, absence of "materiality," has led Faulkner (Brief, pp. 51-55), to take sharp issue with Judge Werker's obviously correct holding that section 12(2) of the Securities Act is the provision to be consulted in determining the consequences of the failure to disclose by name that Tobey & Kirk was or might be deemed to be an "underwriter," and to its insistence that the appropriate remedial section is section 12(1).

Faulkner argues at page 53 that omitting prescribed information from a prospectus exposes the seller to the virtually automatic liability of section 12(1) of the Act, whereas using an "inaccurate" prospectus subjects the seller only to the less stringent liabilities of section 12(2). The contention is without

merit. While not explicitly so restricted, it is the common understanding of the securities Bar that section 12(1) is the remedial section applicable to sales of <u>unregistered</u> securities or to complete failures to deliver a prospectus when one is required, not to sales of securities sold pursuant to a registration statement and delivered with a prospectus which misrepresents or omits material facts.

Faulkner's analysis conveniently overlooks the fact that section 12(2) by its terms applies not merely to prospectuses which are "inaccurate," but also to prospectuses which

> "omit to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and [the seller] not sustain[ing] the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission."

What is charged here is an "omission." There is no suggestion that the "omission" of Tobey & Kirk's name made untrue or misleading any other affirmative representation in the prospectus, *cf.*, *Wessel* v. *Buhler*, 437 F.2d 279, 283 (9th Cir. 1973): The identity of plaintiffs as selling shareholders is set forth; the legal conclusion---that both *they* and any broker through whom they sold their stock might be "deemed to be underwriters" within the meaning of the Securities Act---is also set forth; Faulkner dealt directly with plaintiffs, closing the transaction with their broker, Tobey & Kirk, so that the actual prospectus disclosures and Faulkner's own knowledge disable it to claim that it was a "purchaser not knowing of such untruth or omission."

Moreover, given the issuer's counsel's communication to plaintiffs of the Staff's acquiescence in his "undertaking"---plainly authorized under section 7 or 10(a)(4) of the Act, 15 U.S.C. §§ 77g, 77j(a)(4)---can plaintiffs properly be stripped of the defense in section 12(2) based upon their reasonable care?

Faulkner's reading of the Act and the applicability of the two remedial subdivisions of section 12 is singularly illogical. It would give far more serious consequences to the failure of a prospectus to include statutorily required information which by hypothesis renders no statement therein false or misleading and is even known to the purchaser, than to a prospectus which ostensibly conforms to the requirements of section 10 and contains the statutorily required items of information, but which contains omissions which make misleading other statements therein contained. The argument is specious.

While Faulkner perforce stresses the unusual case of SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1098-99 (2d Cir. 1972), for the proposition that failure to set forth all required information in a prospectus is remedied under section 12(1), that was not the holding of this Court, and its actual holding does not support Faulkner's reading. While recognizing that the prospectus therein violated section 5(b), this Court said, id., at 1098:

> "We hold that implicit in the statutory provision that the prospectus contain certain information is the requirement that such information be true and correct. . . . A prospectus does not meet the requirements of § 10(a), therefore, if information required to be disclosed is materially false or misleading. Appellants

violated § 5(b)(2) by delivering Manor securities for sale accompanied by a prospectus which did not meet the requirements of § 10(a) in that the prospectus contained materially false and misleading statements with respect to information required by § 10(a) to be disclosed." (Emphasis added).

It was not necessary for this Court to elect between section 12(1) and section 12(2) since Manor Nursing was an SEC injunction action, and the Commission's right to injunctive relief did not depend upon such an election. However, even if the Manor Nursing case could be read to have applied a section 12(1) type of liability, Judge Werker properly distinguished it below when he said, CCH Sec.L.Rep. ¶ 95,463, at p. 99,349 (A-15):

> "The discrepancy between the facts as presented in the prospectus prepared for the Manor Nursing Centers distribution and the facts as they actually existed was so tremendous that a failure to amend the prospectus could be deemed an utter failure to provide a prospectus which conformed to § 10(a). Such an argument cannot be applied to the circumstances of this case."

Objectively, no one could reasonably argue that such an argument should be applied to the sort of putative omission complained of in the case at Bar.

(d) The exculpatory provisions of § 19(a) of the Act apply to plaintiffs' conduct

We have little to add in reply as respects our effort to sustain the contract by reference to section 19(a), save to note the arcaneness of Faulkner's purported distinction of A. C. Frost & Co. v. Coeur D'Alene Mines Corp, 312 U.S. 38 (1941), by saying (Brief p. 55, nt.) that here "Faulkner has not elected to affirm the contract." In Coeur D'Alene the defendant also had elected not to affirm the contract, but the Court held that he

was not entitled to disaffirm unless he was able to do so in conformity with the remedial provisions of the Securities Act.

Faulkner contends that plaintiffs did not conform to the Commission's request, or to counsel's instructions, because Byrnes waited to send his letter to counsel until June 14, 1971, instead of responding immediately. This contention is insupportable. It is undisputed that the terms of the undertaking with the Commission, and the issuer's counsel's resulting requests for information, were mailed to plaintiffs on June 3, 1971. Assuming plaintiffs' receipt thereof on Friday, June 4, 1971, and their immediate response on that date, it is plain that plaintiffs' resulting disclosures could not have been included in the registration statement: Byrnes's letter could not have been received in New York before Monday, June 7, 1971, and the registration statement was actually declared effective in Washington, D.C., around noon of that date. The assumption that plaintiffs actually received counsel's letter by Friday the 4th or that he could have received their response by Monday the 7th is highly optimistic, given the state of the mails. Moreover, the fact that the Commission did not wait to receive the information before declaring the registration statement effective itself argues against Faulkner's contention.

Furthermore, the issuer's "undertaking" with the Commission related to <u>two</u> registration statements, the second of which was not even declared effective until June 14, 1971 (A-121, ¶ 7(d)), the very day Byrnes actually wrote to counsel. On Faulkner's own analysis (Brief, p. 58), the issuer would be

obliged to review all shareholder reports to determine whether any broker satisfied the 10% test by reason of sales for more than one shareholder. Thus there can be no suggestion that White Shield Corporation intended to file daily amendments to the two registration statements, even before both of them had become effective, or that the overworked Commission Staff contemplated that it would do so. Accordingly, Byrnes's failure to send his letter to counsel until June 14, 1971 can scarcely have resulted in any delay in the public supplementation of the prospectus disclosures.

Even if the failure of the prospectus to identify Tobey & Kirk by name as an "underwriter" is not supportable under section 19(a), because plaintiffs are suing rather than being sued, the Staff's agreement sustains the adequacy of the prospectus under the authority given the Commission by sections 7 and 10(a)(4) of the Securities Act, 15 U.S.C. §§ 77g, 77j(10)(a)(4), to permit omission of statutorily required information.

The Third Affirmative Defense has never had any validity. The Court below erred in not granting summary judgment to plaintiffs on the Third Defense, and its decision refusing to do so should be reversed.

POINT VIII
(Answer and Reply to Faulkner's Point VI)

THE DISTRICT COURT ERRED IN DENYING PLAINTIFFS SUMMARY JUDGMENT DISMISSING THE SEVENTH AFFIRMATIVE DEFENSE

In its Seventh Affirmative Defense, Faulkner complains that plaintiffs did not resell their stock immediately after

Faulkner's rejection of the trade. As it has done with each of the more substantive defenses, Faulkner gratifies its penchant for taking some statutory (or decisional) language, and, by wholly ignoring its purpose and policy, twisting it to serve the needs of the moment---in this case to relieve it from its liability for breach of contract.

Faulkner stresses Bache & Co. v. International Controls Corp., 339 F.Supp. 341 (S.D.N.Y. 1972), aff'd., 469 F.2d 696 (2d Cir. 1972), which it reads as establishing a rule that any resale more than one month after the breach of contract is "unreasonable" as a matter of law, irrespective of the circumstances. In Bache a tender-offeror had refused to accept plaintiff's tenders of securities, dealing in all respects directly with the plaintiff itself. Following the rejection, plaintiff resold some of the securities over a period of some two years. Because of the need for some sort of cut-off, Judge Levett held that resales made more than one month after the breach were not "reasonable" and denied any recovery thereon. In Bache there was absolutely no legal issue as to the validity of the contract such as might have inhibited the plaintiff from immediately reselling the rejected stock for the defendant's account. Defendant had simply refused to perform a straighforward contract.

Here, in contrast, the contract was rejected by Faulkner's in-house counsel, Mr. Green, because of its alleged illegality under Jaffee, a decision the precise scope and holding of which was and remains uncertain. After the securities in suit were rejected, counsel for plaintiffs and for Tobey & Kirk attempt-

ed to persuade Faulkner's in-house counsel that Jaffee did not preclude the consummation of the sale. Despite Faulkner's present contention that it never vacillated in its refusal to go through with the deal (a position which would certainly seem to estop it now from fixing damages as of June 15, 1971), it met with the sellers and their representatives, and assured them that it would consider possible legal avenues for consummating the transaction (A-249, 415).

Faulkner intimates (Brief, p. 100) that plaintiffs were speculating against the market, and that the law intends to discourage such speculation by requiring either an immediate sell-out for the buyer's account or the conscious election to hold the securities for the buyer's account. However, as we have noted (Principal Brief, p. 87; A-251-52), plaintiffs were pressing Ross daily as to developments, in a desire to resell their stock, but he believed that the matter was being handled by counsel and did not wish to insert himself. Moreover due to the uncertainty as to the legal position, plaintiffs could not risk gambling against the market because they might end up swallowing the loss.

In retrospect we know that all discussions with Faulkner actually terminated on June 23, 1971, after another break in the market price of White Shield stock. However, as late as the institution of this action it was the belief of the plaintiffs, reflected in their initial complaint, that discussions between Faulkner's counsel and Tobey & Kirk's counsel had continued up to the moment the resales commenced in August 1971. Faulkner suggests

(Brief, p. 104), that Ross lied to the plaintiffs in telling them that negotiations with Faulkner were continuing. Yet the affidavit of Peter Landau, Esq., one of the counsel for Tobey & Kirk, confirms that it was not until on or about August 6, 1971 that he advised Vincent Ross that the transaction could not be consummated (A-197).

This fact underscores another significant aspect of Faulkner's "rejection" upon which insufficient stress may have been placed because, as Faulkner itself says (Brief, p. 101), the parties and the Court below were preoccupied with "weightier issues." Faulkner evidently assumes that Green's advice to Ross on June 23, 1971 that the contract was "illegal," sufficiently gave notice to plaintiffs so as to start the running of their time to resell. Given the intervention of lawyers on both sides with respect to what had become purely a question of law, it is doubtful that a lawyer's advice to a broker who is represented by counsel is binding on the broker's customer, who also is represented by counsel. _Faulkner at no time notified the attorneys either for Tobey & Kirk or for the plaintiffs_, with whom Mr. Green had dealt, that it was Faulkner's counsel's "final" legal conclusion that _Jaffee_ precluded its consummating the sale. Yet by June 23, 1971, the matter was being handled exclusively by Faulkner's house counsel, Green, and he was functioning purely in his legal capacity as was implicitly conceded by Faulkner itself when, on Green's deposition, he was instructed not to testify, on grounds of attorney-client privilege, as to what disclosures were

made to him by Faulkner's traders prior to the meeting of June 21, 1971 (A-417-18, 432-33, 441).

Prior to the June 21, 1971 meeting, Green had discussed the legal issues with Raymond Merritt, Esq., counsel for plaintiff Byrnes (who told Green that he did not agree with Green's reading of the law, and offered to arbitrate on Byrnes's behalf) (A-403-04), and also with Melville C. Hicks and Peter Landau, Esqs., of Tobey & Kirk's law firm (who also disagreed with Green's legal conclusions (A-398-401)). Following these discussions, Green and various of Faulkner's trading personnel met with plaintiffs and Ross on June 21, 1971, to review the facts. Green explained that the trade was unlawful under Jaffee---which "encompassed everything that was transpiring here, and it was easy to say with one word" (A-402)---but agreed to see if there was any legal way for Faulkner to go through with the deal (A-249, 415). In fact he explored nothing, not even bothering to re-read Jaffee before purporting to cancel the trade two days later after a further market downturn.

However, given the intervention of attorneys in the situation, we submit that on elementary principles, Green's "final" conclusion that the transaction was unlawful was not properly communicated until it had been communicated to counsel. Plaintiffs and Ross themselves believed that the matter was being handled by counsel, and their belief was not unreasonable in the circumstances. Since the decision to cancel the trade was ostensibly a legal one (even though, in fact, Green had never researched

it), elementary courtesy or normal professional ethics would have required him to advise counsel on the other side that it was his legal conclusion that the transaction was prohibited by law. No such notification was given to counsel, and passing on a legal conclusion of some complexity to a layman who was represented by counsel is at best an unprofessional and unethical way of proceeding.

We respectfully submit that in such circumstances the June 23, 1971 date is not conclusive, and that even if it were, there is nothing in the policy of the Uniform Commercial Code which requires that the delay of six weeks between the "final" rejection on June 23, 1971 and the commencement of resales on August 9, 1971, be held, as a matter of law, to throw the entire loss inexorably on the plaintiffs, particularly since it would in normal course have taken at least that long to obtain a ruling or exemption from the SEC under Rule 10b-6(f).

We do not believe that on the facts of the present case <u>Bache & Co</u>. v. <u>International Controls Corp</u>., <u>supra</u>, 339 F.Supp. 341 (S.D.N.Y. 1972), <u>aff'd</u>, 469 F.2d 696 (2d Cir. 1972), compels a different result. Can it be doubted that recovery there would have been allowed if the resales had been made some six weeks after the breach (rather than over a two year period), particularly had there been questions as to the legality of the contract and discussions were had between counsel for the parties between the breach and commencement of resales. We submit it cannot, and the fact that the arbitrary choice of one month as a cut-off was

sustained by this Court on the actual facts of Bache does not mean that in every case, regardless of the facts, resales after one month preclude recovery of damages.

Nor is there any merit to Faulkner's argument that because there were a number of market-makers in the Pink Sheets that that is "evidence of extensive bidding" (Brief, p. 105). The conclusion itself is a non sequitur, and we have already dealt with that subject in our principal Brief (p. 92). Moreover, the facts negate Faulkner's contention: the original contract price MacMillen offered Santangelo itself was a discount from the then market price because of the size of the block (A-287), and the testimony of Ross, that the market was weak following the "final" rejection on June 23, 1971, is itself reflected by the published Pink Sheet prices (A-108-09).*

Faulkner says (Brief, p. 106), that even if the market was weak and would not support a big trade, plaintiffs "could have commenced selling in June 1971 the very same way they commenced selling in August," i.e., in relatively small lots. That argument assumes that plaintiffs' actual resales did not themselves have a depressing effect on the market price because of

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*It is characteristic that while Faulkner would make the Pink Sheet prices conclusive as to the available market price for purposes of the Seventh Defense (in order to infer prejudice to itself), in connection with its cross-appeal from the dismissal of its counterclaims, it argues (Brief, p. 123), that plaintiffs "presumptively destroyed the market price as an accurate indicator of value . . . [and] in effect profited further therefrom in successfully persuading the District Court to employ that market price on the settlement date . . . in arguing that Faulkner did not sustain a loss on the transaction [its purchase and resale]."

the number of shares they sold. Yet it is possible to infer from the stipulated facts that the volume of plaintiffs' resales, although staggered, themselves had a depressing effect on the market. Plaintiffs commenced their resales on August 9, 1971 and finished them on September 29, 1971. Although the high bid price in the Pink Sheets had not been above $9-1/2 since July 29, 1971, and it fell during the resale period. Yet, on October 1, 1971, two days after plaintiffs had completed their resales, it rose to $9-5/8, staying at or above that price for roughly two weeks, and on several occasions rising to $10 per share or higher (A-109-10).

Having created the Hobson's choice for plaintiffs by cancelling the contract without a reasonable investigation of the propriety of its claimed reasons for having done so, Faulkner now implicitly suggests that because of the turmoil and confusion created by its cancellation, plaintiffs' sole remedy is against Tobey & Kirk or its counsel, or, for that matter, against anyone other than Faulkner. There is no equity in such a position, and its failure to comply with its own obligations to observe Jaffee by obtaining copies of prospectuses, its rejection of the trade without its counsel's even having reread Jaffee, its own speculation on the market during the period between June 15, 1971 and June 23, 1971, and its counsel's failure to communicate his legal conclusions to counsel for the sellers and their broker, estop it now from complaining of plaintiffs' putative delay in commencing their resales.

The resales of the stock commencing in August 1971 were "reasonable" as a matter of law, Faulkner should be estopped to contend otherwise, and the Court below erred in denying summary judgment to plaintiffs dismissing the Seventh Affirmative Defense.

CONCLUSION

THE COURT BELOW ERRED IN DISMISSING THE COMPLAINT. IT CORRECTLY GRANTED SUMMARY JUDGMENT TO PLAINTIFFS ON FAULKNER'S FOURTH, FIFTH, SIXTH, EIGHTH AND NINTH AFFIRMATIVE DEFENSES, AND PROPERLY DISMISSED ITS SECOND AND THIRD COUNTERCLAIMS. THE COURT ERRED IN GRANTING SUMMARY JUDGMENT TO FAULKNER AND IN DENYING SUMMARY JUDGMENT TO PLAINTIFFS ON THE SECOND AFFIRMATIVE DEFENSE, AND IT ERRED IN DENYING SUMMARY JUDGMENT TO PLAINTIFFS, AS A MATTER OF LAW, ON FAULKNER'S FIRST AND THIRD AFFIRMATIVE DEFENSES. ON THE SEVENTH AFFIRMATIVE DEFENSE THE COURT ERRED IN DENYING SUMMARY JUDGMENT TO PLAINTIFFS BECAUSE THEIR CONDUCT WAS REASONABLE IN THE CIRCUMSTANCES AND BECAUSE FAULKNER IS ESTOPPED TO COMPLAIN OF ANY DELAY IN COMMENCING THEIR RESALES.

Respectfully submitted,

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CERTIFICATE OF SERVICE

REGINALD LEO DUFF, attorney for the plaintiffs and counterclaim-defendants, appellants, appellees, Thomas J. Byrnes and Francis R. Santangelo, hereby certify that on the 2nd day of October, 1976, I served at least two copies of the within Answering and Reply Brief, by mail, upon the following:

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